

LIMITED PARTNERSHIP REORGANIZATIONS, OR "ROLLUPS"

HEARING
BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED SECOND CONGRESS
FIRST SESSION
ON
THE WIDESPREAD INVESTOR LOSSES IN LIMITED PARTNERSHIP ROLL-
UPS, AND ABUSES THAT REPORTEDLY HAVE RISEN IN THE \$130 BIL-
LION MARKET FOR PUBLICLY HELD LIMITED PARTNERSHIPS

FEBRUARY 27, 1991

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WEDNESDAY, FEBRUARY 27, 1991

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The committee met at 9:35 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The subcommittee will come to order.

Let me welcome everyone here this morning for a hearing by the Subcommittee on Securities on the issue of limited partnership rollups.

Let me at the outset invite our first panel of witnesses to join us here at the table. Margaret Hooker, who is from New Canaan, CT; Ron Rybicki from Detroit, MI; Richard Wollack, who is chairman of Liquidity Fund Management, Inc., from Emeryville, CA; and Mr. Lee Errickson, who is the managing director of Robert A. Stanger & Company from Shrewsbury, NJ. There are names there. You can find them along the way.

Let me welcome all of you here this morning and thank you, particularly our witnesses who are going to be speaking on more of a personal level rather than a technical one, for being willing to come forward here this morning to share your own experiences with this particular issue that we're dealing with here this morning.

Since 1980, an estimated \$130 billion in public limited partnership interests have been sold to U.S. investors. So of 11 million investors in these partnerships, an estimated 8 million are small investors, with an average investment of \$10,000.

As small as this might sound to some who may be in our audience here today, for many of these individuals the \$10,000 or \$20,000 they have invested represents the bulk of their life savings. None of these investors believed they were getting a risk-free return. And that's an important point to make here today. Not suggesting that people ought to be absolutely protected when they become involved in limited partnerships.

But in some cases, many cases, rather, promises were made to them. First they were told that they would receive distributions from the partnerships on a yearly or periodic basis. And that, in

certain period of time, usually 8 to 10 years, all of the property bought by the partnership would be sold. At that time, it was promised as well that the investors, the limited partners, would receive proceeds from the sale of the remaining property and other assets. They also believed the general partners had a great incentive to look out for the interests of the limited partner investors because, except for the management fees, the general partners could not take any profits out of the partnerships until the limited partners had received their share.

But the assets of many partnerships, especially those invested in real estate, have declined in value. The general partners have been unable to sell new partnerships. Their fee base is declining and their prospects for taking a profit after paying off the limited partners has declined dramatically.

Now limited partner investors are finding that the deals are being changed. And this is what we want to focus on. Many general partners are attempting to roll up existing limited partnerships into new entities.

Investors in 31 States have written to me about what they believe are serious abuses in limited partnership rollups. I might add that, in the time that I have served as chairman of this Subcommittee on Securities, I have never received more correspondence on any other single issue than I have on this one from people across this country. It's the single most—the issue that has drawn the single largest response from consumers and others who are involved in these partnerships.

Many say that they have been confused, and understandably so, by the 200- and 300-page proxy statement prospectus. They have been pressured to vote yes for the rollups. And even if they vote no, they are being forced into an investment they had no intention of being in.

Of course, they can sell the shares of the new rolled up entity. But according to witnesses on our first panel this morning, investors have seen an average, an average decline of 63 percent in the value of the new rolled up security, including a dramatic drop of 44 percent on the very first day of trading.

Today we will hear from two investors who have had firsthand experiences. Their limited partnership investments which were performing to their satisfaction were combined with other limited partnerships to form a new entity. Each investor lost more than 70 percent of the value of their original investment.

Let me say to our investor witnesses, your assistance and your testimony here today is invaluable. Too often Congress gets its information largely from the industry or from the regulators and it's really the investor that we ought to be hearing more often from.

Later this morning, we will hear from both Federal and State regulators, the SEC, the State Securities Commissions, all have separate but limited regulatory authority over limited partnerships and the resulting rollups.

Let me take just a moment to outline some of the major questions that we hope to address this morning.

First, are the risks to investors fully and fairly disclosed? Are they disclosed in the original limited partnership's offering? Are they disclosed in the rollup proxy statement?

Obviously, it's not the number of pages in a document that determines the quality of disclosure, but whether the information on it is clear and understandable to the average investor.

Second, is disclosure enough? Should there be other protections for investors to ensure that the transactions are in fact fair?

Third, what remedies does an investor have when he or she votes no for the rollup, but still is forced to take shares in a new entity, shares that we are told on average decline, as I mentioned a moment ago, 44 percent. This is on the average, declining 44 percent on the very first day of the offering. That's the average decline.

Fourth, what are the responsibilities of the general partner to the limited partnership investors? In the deals we've looked at, the general partners obviously have a financial incentive to roll up the partnerships. But in all these cases, the limited partners have lost huge sums of money.

Fifth, what are the responsibilities of the broker-dealer community in rollups? If you have a situation where brokers are paid only for delivering yes votes, what broker in his or her right mind is going to tell his customer to vote no, even if a no vote happens to be in that customer's best interests?

Sixth, what are the regulators doing—are the regulators doing their jobs individually and are they working together to protect investors in these transactions?

A number of steps have been taken. But we need to know whether the regulators have the tools necessary to do the job.

As a caveat to all this, we have to acknowledge, as I said at the outset, that in many cases the original investments turn sour not because of fraud or mismanagement, but simply because the partnership assets, in some cases real estate and in other cases oil and gas investments, just lost their value. That's the risk you take. We are not here to protect investors from those kinds of risks.

So we need to sort through the facts this morning and try to determine to what extent investor losses have been caused by actual abuses on the part of promoters and securities professionals. And I'm sure that our distinguished witnesses will help us do just that.

Finally, let me say that there are other groups who wanted to testify here this morning. We could not accommodate everyone. And we have invited them to submit written testimony to assure that our hearing record is complete before any action may be taken by this subcommittee or the full committee or the Congress of the United States.

Again, we have excellent witnesses here this morning. This is an issue, as I said a moment ago, that has attracted more mail and more inquiries than any other single issue we have had before this subcommittee.

And I see my distinguished full committee chairman is here with us, and my distinguished colleague from New York as well, so I will, before turning to our panel of witnesses, ask them—first of all, thank them for coming and also ask them if they have any opening comments.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Well, thank you, Senator Dodd, and I want to commend you for your outstanding leadership as subcommittee chairman on this issue today and on the full range of issues within this subcommittee. And I'm very pleased you've taken the initiative today to hold this hearing to look into the allegations that limited partnership reorganizations which, as you note, are referred to as rollups, have subjected public limited partners to unfair practices by the general partners.

This hearing is a first step in determining whether current law adequately protects public limited partners. And if not, we have the basis to consider additional legislative steps that we would want to take.

The strength of the U.S. capital markets rests upon investor confidence and the integrity of the market. This committee and the Securities Subcommittee have a special responsibility to ensure this market is fair.

As a result of this committee's effort, and particularly those of Senators Dodd and Heinz, the last Congress enacted the Security Law Enforcement Remedies and Penny Stock Reform Act, a far-reaching bill that greatly strengthens the SEC's enforcement efforts. So today's hearing is really a continuation of our efforts to protect individual investors.

I am pleased that the subcommittee will hear from a variety of witnesses about limited partnership rollups. And I want to particularly welcome Mr. Ron Rybicki, a Michigan resident, who will testify as to his personal experiences as a limited partner in an investment that was rolled up.

I want to also note for the record in reference to the case that Mr. Rybicki and other Michigan investors were caught up in, that I have passed certain allegations about this transaction on to the Chairman of the SEC by letter, as I'm sure our witness knows.

As the chairman of the subcommittee knows, we're handling a major legislative matter on the Senate floor today, which I must handle starting at 10, so I'm going to have to excuse myself in a short time.

But I want to say to our witnesses, and particularly to the Michigan witness who is here, that we appreciate your coming. I'm distressed about the facts in this case. We want to see what actions might be possible, what lessons we can draw from it, and what other safeguards are needed in the future.

Senator DODD. I'd like to say to the chairman and point out to my colleague from New York as well, just to give you an idea of the magnitude of what we're talking about here in terms of the number of people, in my State there are 152,000 people who are involved in limited partnerships with an average investment of \$11,000, a little more than that. In Michigan, there are 317,000 people with the average investment of \$10,000 involved in these arrangements. In New York, there are 749,000, with an average investment of \$8,000. In fact, a smaller investor in New York, in many ways, to other States—not the smallest in the country but one of the smallest, I might add here.

So it involves a lot of people who are affected by this.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Well, Mr. Chairman, let me commend you for calling this hearing. Not only calling it, but for focusing in on this issue. And it may indeed give some people cause for concern. But maybe the light of day is important. I think that is the best protection that we can give to shareholders, the investors, the opportunity to have not only full disclosure, but to have the light of what is taking place be available to them.

Partnership reorganizations which are referred to as rollups are sometimes called pushovers. Apparently, there is much concern that unsophisticated investors are unknowingly and sometimes unwillingly consenting to their limited partnership interest being pooled with other limited partnerships into new publicly traded securities. The newly formed securities hit the open market with a whimper and limited partners feel that they have been sacrificed and fleeced for the financial benefit of the general partner, and that happens to be one of the problems.

Since 1980, the U.S. investor has purchased approximately \$130 billion of limited partnership interests in enterprises such as real estate, oil and gas facilities, and others.

After California, Mr. Chairman, as you have indicated, New York has the largest number of limited partners, approximately 750,000, with an average investment of \$8,387. So it is a small investor, as you have indicated.

Now, clearly, the partnership rollups have become a popular investment vehicle, at least to the general partners who have formed them. Partnership reorganizations are slipping through without being subject to the normal State merit review process because they are to be listed on a securities exchange and only 51 percent of the vote of limited partners is required to alter the original terms of the partnership agreement, and relatively unsophisticated investors receiving volumes of materials to sift through in order to vote on the partnership conversions.

Subjecting the rollup to State review, enhanced disclosure requirements and dissenters rights would address some of these abuses. And the question is, what role if any should the SEC have in relationship to this? What is the proper Federal role? Should we leave this just to the States.

Investors are also concerned about the drop in value of their investment from the share price targeted by the general partner to the open market trading price. At the same time, the general partner has an incentive to increase the projected share price so that he may obtain a larger share in the rollup.

Enhanced disclosures of the valuation methods would reveal the actual value of the limited partner's interest in the new securities. This should close the gap from what the general partners project as the value of new securities and what the market will actually bear.

The reorganization process of partnership interest deserves our attention. And I want to commend you again, Senator Dodd.

We should know, however, to rebuild the entire process when only a minor tuneup is needed would certainly be the wrong move. I think the Securities and Exchange Commission has been studying this. I'm not suggesting that we adopt any one method. But certainly I think that we have to review very closely and very carefully the magnitude of the problems, don't make them bigger than they are. Let's not overregulate it. But, by the same token, I think that there is a necessity for some action.

If that action doesn't come with NASDAC or doesn't come on the State side, I think that we may be forced to mandate some and see to it that these investors are protected.

And I thank the chairman.

Senator DODD. Thank you, Senator D'Amato.

Senator RIEGLE.

Senator RIEGLE. Mr. Chairman, I should clarify, so there is no misunderstanding, with respect to the case, the Concord case, what I have done by letter is to convey the allegations to the SEC. They, obviously, have to decide whether on the basis of the allegations whether they pursue an investigation and that is not a public matter unless they make it public. So I would not want to leave the impression that we compel them to do something here. That isn't the way that works. But they have been forwarded to them and it now will involve a process within the SEC to decide whether some further steps might be required.

Thank you, Mr. Chairman.

Senator DODD. Thank you, Senator Riegle.

Before we start, I have a statement for the record from Senator Sanford that will be inserted at this point.

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Mr. Chairman, I am very glad that the Securities Subcommittee today is taking a look at limited partnership reorganizations or "rollups". I believe this is a very important topic which we in Congress must address. I am pleased at the variety of witnesses which includes not only SEC Chairman Richard Breeden but also State securities commissioners, industry participants and investors. It is my hope that their differing perspectives will give us some valuable insight into this issue.

As you know, publicly held limited partnerships now constitute a \$130 billion market. An estimated 11 million investors have purchased these limited partnerships. I believe there are over 116,520 limited partners in North Carolina alone.

I understand that the practice of rollups, which combine independent individual limited partnerships into a single new entity that publicly trades on a national securities exchange, is a fairly recent phenomena. Given the large number of individuals involved in limited partnerships, I am very concerned about reports of widespread investor losses and rampant abuses connected with limited partnership rollups.

A number of my constituents have contacted me to express their concerns that they believe they have been given an unfair deal in such rollups. They have come to me with concerns that the small investor has very little say in these rollups and that the resulting

securities often sell at deeply discounted levels from the perceived values of the partnership interests prior to the rollup.

It is no wonder that they are upset. According to one source, 94 percent of the rollups to date have lost money for limited partnership investors, and investors on average have realized an average decline of 69 percent in the value of the "rolled up" security.

Clearly, it is time for the Senate to address this issue. I am very interested to hear suggestions from our witnesses as to what types of reform appropriately address the reported problems connected with rollups, and I hope that from this hearing we can come up with some solid proposals as to how Congress can ensure limited partners receive fair treatment and deserved returns on their investments.

Thank you, Mr. Chairman.

Senator DODD. I might point out, by the way, just because I know you have to run over to the floor, but it might be interesting.

This is the prospectus that Mr. Rybicki was involved in. This is 247 pages. And some of it is fairly clear. I mean, this is not all impossible to understand and you don't necessarily have to be an expert. But a lot of it is very, very technical and complicated material and to expect a small investor to necessarily understand everything that's involved in here—it may be full disclosure that you find in here, but it makes it a little more difficult than the average person. That's what your response would be.

But anyway we thank you all for coming here.

Ms. Hooker, we want to thank you for coming from Connecticut.

Are you any relation to the Thomas Hooker that helped found Connecticut?

Ms. HOOKER. I'm not sure. [Laughter.]

I got the name by marriage. [Laughter.]

Senator DODD. Anyway, thank you for being here. We'll start with you.

Ms. HOOKER. Shall I go ahead?

Senator DODD. Yes, please.

STATEMENT OF MARGARET HOOKER OF NEW CANAAN, CT

Ms. HOOKER. OK.

In April 1978, I invested \$25,000 in the McNeil Eight Real Estate Partnership. The reason I made this investment at the time, I was told that I would receive a small annual return, 3 to 4 percent. The partnership funds would be invested in a variety of garden apartment complexes and shopping centers all over the country. At that time, it was the Sun Belt, the oil patch. And that the holding period for the properties would be approximately 8 to 10 years. At that time, the properties would be sold and I would share in the proceeds of the share of the properties.

If you remember back in the late 1970's, there was no such thing as real estate not going up two to three times, easily, in a period of 8 to 12 years. I was also, at that time, 36 years old. So I was trying to accumulate capital for retirement. I had a good job; I wasn't in need of current income. So the primary objective of my investment was to build a nest egg for retirement for when I needed the money.

I also felt that it was a fairly conservative investment. There were other people I knew who had a lot more money than I did who were buying these really fancy tax shelter investments with double writeoffs and what have you. The McNeil partnership was not sold to me on that basis. It was sold to be a relatively conservative investment by which I would participate with capital appreciation over time, and that's what I was looking forward to.

From, say, 1978 to 1984, I was very satisfied with my investment. I received semiannual checks which I think approximated 3 percent of my original investment each year. I received mailings from the McNeil people telling me how well leased the properties were. They were repairing the parking lots, planting rose bushes, really taking good care of these places.

So I felt so good about it that I made a smaller investment in a second McNeil partnership some time in that period, I'm not sure exactly when.

As I go back through my records, it was about 1985 that things began to not look quite so perfect. The partnerships were coming into a cashflow problem and they stopped paying the semiannual distributions. I began receiving letters from Liquidity Fund on the—offering to buy out my interests in these partnerships at far less than my original investment. But I have to say for Liquidity Fund that their offers were very clear and to the point and they were sold on the basis if I didn't want to wait to get my money back, they would give me part of my money back now. Their presentation was very honest and direct.

I didn't—I wasn't in any hurry to get my money out, so I did not take advantage of their offer. As I say, I was trying to save money for retirement.

I think it was 1986 the distributions finally stopped on the McNeil Eight Partnership. In 1987, I received a prospectus. I can't believe I still have this, but 276 pages from National Realty Limited Partnership. There is a short question and answer summary at the end, which is what I—about all I was really able to read from it.

But it appeared that they were taking my partnership, which I thought was very successful, high occupancy rates, I thought that the partnership was doing very well, they were rolling it up with 35 other partnerships, most of which were much smaller. I had no idea how those other partnerships were performing. They could have been real dogs for all I knew. And this was going to be something that was going to be publicly traded.

All of a sudden, I say to myself, I'm supposed to get the proceeds from the sale of my garden apartments. This is obviously not going to happen because they talk about making distributions and about reinvesting, buying more properties. So I'm never going to get this nice check at the end of the 8- to 12-year holding period.

I called my broker to ask her what to do. She really didn't have a strong opinion about it one way or another. But she said, what can the little guy do? You probably, if you vote no, you have to go along with the majority who votes yes and most people get pressured into voting yes for these deals, so do what you want but I don't think it will serve any purpose for you to vote no.

In the end, I did vote yes. I have had some experience on the corporate side with dissenters rights, working for corporation and shareholder relations. I couldn't find anything in this prospectus that had any dissenters rights whatsoever. It appeared that I could vote no and, if 51 percent of the people voted yes, I was stuck with it, or I could vote yes. I probably should have voted no on general principle.

But I did vote yes and among other reasons why I did vote yes, I was able to determine that, based on the conversion price—what did they call it, an arbitrary value of \$10, that my \$25,000 investment would have been worth \$48,000. It probably also would have been worth \$48,000 if I put it in a savings bank. But then they tell you the market price could be substantially less.

Now what does substantially less than \$10 mean to you? I said, well, maybe it means \$7, \$8, \$5. It turned out, it meant \$3, or exactly \$3.875, I think it was, by the time I saw a quote in the paper or by the time I actually had my certificates. I have a feeling it may have started trading before I got my certificate. I don't know.

By the time I realized what was going on, \$10 had turned into \$3.875 and \$48,000 had turned into \$18,000 and change.

I watched it for a short period of time and then I was just so fed up and disgusted I sold for about \$11,000, which I gather was a good thing to do because I looked a couple of days ago and the value of—if I had not sold my original investment would be worth \$1,832.

In summary, I just believe that I was—I was kind of taken advantage of. I read an article in the Wall Street Journal just yesterday which says if you—for any limited partner who does not need the money, they are by far to this very day better off just holding—I mean doesn't need it immediately—I mean, obviously, you need it—you are by far better holding the properties until they are sold than being forced into liquidating investment under terms that you simply have nothing to say about.

I was saving on a long-term basis. I wasn't too upset when the distribution stopped. I wasn't too upset about a few bad times here and there. I mean, every company goes through bad times here and there. I was looking over the long term. And I still can't believe that a garden apartment complex purchased in 1978 isn't worth more now than it was then, unless it's been grossly mismanaged, which I don't believe it was.

Senator Dodd. Thank you very much.

Mr. Rybicki.

STATEMENT OF RON RYBICKI OF DETROIT, MI

Mr. RYBICKI. Mr. Chairman, I would like to share with you yet another deplorable financial experience.

Some 4 years ago, I purchased from an agent a limited partnership called Concord Milestone Income Fund, later to be called Milestone I. The parent company was Concord Assets Inc. of Boca Raton, FL, now called Milestone Properties, the call letters MPI, and now trading on the New York Stock Exchange.

A purchase of 20 units, \$20,000, was for me the culmination of 1 year's research effort in tracking, asking critical questions, and ul-

timately placing trust in both the agent and the limited partnership plan. It was the most comprehensive, conservative limited partnership I could find at the time. Far from stock market risks, it had some inflation resistance and was very solvent. By no means was the plan speculative nor was it a get-rich-quick scheme, nor did it pay outrageously. It paid 9 percent annually with a promised increment of some 4 percent at the end of its 8- to 10-year life.

I also attended three comprehensive sales seminars where, in public, I was provided full open support by Concord representatives that by no means were the funds ever to be blended. After all, the properties in Milestone I were fully owned, rock solid, solvent and with named tenants including Builder's Square and Dillard's Department Store, to name a couple. It was profiled over and over again as rock solid and something that would make my retirement a little easier.

Well, in late 1990, I was sent a huge prospectus with cover letter from Concord indicating their aim to reorganize, and in ways far from original goals. The size, content, language, structure of this prospectus was intimidating to say the least. I forced myself to read it anyway. And, to my total dismay, I couldn't believe what Concord brazenly was about to perpetrate.

Not only did they want to blend my program, the flagship Milestone I program with a highly leveraged and totally undesirable Milestone II program, but they suicidally proposed to go public on the New York Stock Exchange and in a depressed commercial real estate market.

Worse, most original goals of the program were now changed. Infinite life replaced the preagreed on 8- to 10-year liquidity period.

Worse, huge unjustified increases in management expenses, some \$900,000, spread across a handful of allegedly responsible executives.

Worse, certain votes would not require 75-percent shareholder approval. No longer a simple majority. Management controlled 29 percent of the stock, and there was little likelihood the limited partners would ever have a vote.

And worse yet, no dissention rights. I would never be allowed to do anything or say anything with regard to the control of the assets. I was totally captive in multiple ways by management in any decisionmaking, good, bad, or worse.

And worst of all, how so few of the many retired limited partners would have the means, the patience, and the acuity and understanding to tackle that huge prospectus.

Management knew of all these things full well in advance and took advantage of them.

Well, I obviously voted no on my proxy ballot. But in spite of this, I received at least four pieces of mail, one expensive air express. All were suggesting and urging me to vote but all were also stressing that a nonvoting position was the same as a no vote. The message became ever clear over this progression of more mail that, by dwelling on the avoidance of this ominous no vote, Concord was in fact trying to influence my yes vote.

I also received no less than four calls from Concord to my home, each one by a different caller. The one that I allowed used sly

boiler room sway tactics to influence a yes vote, and never a word or review of downside risk. In a word, selective disinformation.

Concord was even going to do us a break, a help, by expanding the proxy voting time several weeks, so that we all could eventually vote yes by one or another of their influencing methods.

To my surprise, the vote presumably passed. I understand that it is presently being challenged in Florida.

Mr. Chairman, I bought product A, Milestone I, because of its specific goals and totally rejected product B, Milestone II, at the time of sign-up because of completely incompatible goals. Yet, look what's happened.

By way of a smokescreen compliance in giving us prospectus, Concord also used sly and unethical mail and boiler room influencing tactics to pull off a yes vote. Unethical and sly influencing methods used, but also unethical in project scope, for no rational person could have ever voted willingly for a giveaway plan guaranteed to fail.

Just one day after the issue went public, the stock was trading at \$3.50. And after transfer, that translated to me 75 percent loss on my hard-earned money earmarked for retirement.

Mr. Chairman, by any reasonable yardstick, the above constitutes a disgraceful breach of contractual obligation and fiduciary trust. The limited partners stood quietly prepared to provide seed money for a viable going concern with specific goals. Sadly, management sold them all out to ensure a cash flow, destined to line the wallets of a handful in control, at the expense of thousands who have now lost their savings nest egg, some still unaware of their big loss.

Mr. Chairman, events in the last month in the gulf have been very sobering from the perspective of strength. We have seen strength in international coalition, strength in military ability and resolve, and also strength in the overwhelming support by the people.

But another measure of this country's strength resides in the financial solvency and fiduciary trust of its financial institutions. Responsible savings and investment committed Americans, many limited partners among them, are indeed a contributing measure of that strength, the wealth of the country. I fear that that great strength is being compromised even as we speak, and in ways that smack of deceit, exploitation, and self-profit by a controlling few.

I am aware of the statistics that suggest some 350,000 people have been already harmed by such plundering rollups, some \$1.5 billion in savings and national wealth lost.

Mr. Chairman, it is a loss we individually cannot accept. It is a loss collectively America cannot afford. America clearly needs to ban all rollup procedures. Disclosure alone is not enough and, in fact, is flawed.

Americans urgently need protective and corrective legislation, and fast.

Thank you.

Senator Dodd. Thank you very much.

Mr. Wollack, we thank you very much for coming this morning to be with us.

I should let you know that all of you, your full statements, will be included as part of the record and any additional material you want to add for the record as well.

You may need that. Why don't you take Ms. Hooker's microphone so we can hear you.

STATEMENT OF RICHARD WOLLACK, CHAIRMAN OF LIQUIDITY FUND MANAGEMENT, INC., OF EMERYVILLE, CA

Mr. WOLLACK. Good morning.

Mr. Chairman and members of the subcommittee, I am Richard Wollack, chairman of Liquidity Fund Management, Inc., a registered investment adviser with 3,000 clients that it manages money for.

You have just heard from two small investors who spoke very eloquently for the more than 275,000 limited partners who have already been victimized in rollups. I am here this morning to add my voice to those calling for an end to the systematic exploitation of limited partners in rollups, the investment world's equivalent of a stacked deck and brass knuckles.

These words may sound inflammatory. But investors such as the two you just heard from this morning, who see their equity stake in the limited partnership all but vanish overnight in a rollup do, in fact, as you have heard, perceive that they have been cheated and pummeled and understandably so.

Both Mr. Rybicki and Ms. Hooker are in real estate programs. As the chart that I have put up here on the easel to my right shows. And here we see that the average real estate rollup trades down 49 percent on the very first day and is now trading at an 84-percent reduction cumulatively. That means that nearly 50 cents of every investor dollar vanished overnight in the average real estate rollup.

So, if limited partners are losing, who is making the money on these deals? Not surprisingly, the general partners and their associates packaging the deals cart away literally obscene fees and commissions. These are the people who hold all the cards as well as the brass knuckles in a rollup.

Consider the following. General partners work in secret months in advance all the while spending the limited partners' money to do the groundwork needed to structure the deal and plan the aggressive proxy campaign. The general partners select the investment banker who puts together the fairness opinion, which is totally misnamed since it does not tell the limited partners whether the deal is fair for them.

Additionally, the general partners write the glowing cover letters that you hear about that accompany the proxy. These propaganda pieces have the unfortunate effect of often encouraging many limited partners to quickly vote yes rather than wade through the hundreds of pages of legalese in the proxy. And the general partners also pay the largely unregulated proxy solicitation firms which take pride in the aggressive boiler room style telemarketing tactics that they use to browbeat limited partners into voting yes. I think Mr. Rybicki's testimony is testament to that. In fact, my testimony contains an exhibit of a press release of one proxy solicitation firm

literally boasting about how it can overpower any limited partner opposition.

Mr. Chairman, I ask you, is this the way for a fiduciary, a general partner, to act?

As if being up against such an intimidating array of high-price legal banking accounting and promotional fire power isn't bad enough, limited partners are disadvantaged in still other ways. For example, Federal proxy rules effectively gag limited partners from talking among themselves to mount a no vote campaign.

Limited partners who understandably want to seek the advice of their broker don't realize that the brokers are only paid for yes votes, not for no votes. Worst of all, the very notion of a no vote is often a cruel illusion, since the aptly named cramdown provisions in most rollup deals herd everyone into the new investment instrument, even if as few as 50.1 percent of the partners vote to go along.

Notwithstanding all of this, some general partners will try to frustrate the growing momentum for serious rollup reform by encouraging half steps or cosmetic changes. For example, they will ask why not just require more disclosure? The problem with that recommendation is obvious. You have held up some prospectuses, Mr. Chairman, of 200 and 300 pages. I hold up here the latest epistle from the latest rollup registered with the SEC. No fewer than 726 pages, weighs nearly 2 pounds of the most convoluted data and legalese you could imagine.

The first sentence of this proxy contains 150 words.

Senator D'AMATO. Sounds like one of my staffers wrote that. [Laughter.]

Senator DODD. By the way, I'm going to include right here, too, your press release which has the—that press release on the Shareholder Communications Corp. I think that's just intriguing to read that. Include that in the record.

news update

SHAREHOLDER COMMUNICATIONS CORPORATION DELIVERS MAJORITY CONSENT ON TWO LIMITED PARTNERSHIP ROLL UPS.

CONSENT DELIVERED DESPITE OPPOSITION TO THE PROPOSED REORGANIZATION.

New York, NY December 1990, Shareholder Communications Corporation ("SCC") has delivered a majority consent in connection with the roll-up of two limited partnerships affiliated with a major investment partnership sponsor.

The consents were delivered in the face of stiff opposition from limited partners, a barrage of bad press against the concept in general and the absence of brokers being paid for "yes" votes.

Working with the general partner, SCC formulated a strategy which enabled it to push the overall vote count high enough to overcome the opposition and pass the issue. SCC used a variety of strategies including one-on-one contact with investors, various types of follow up and reminder mailings as well as enlisting the participation of management for contact with key investors.

SCC specializes in solicitations for the Investment Partnership and Investment Company industries. Currently SCC is under contract on over a dozen roll-ups and has completed 65 transactions for the Investment Partnership industry in the last 24 months.

If you have a consent solicitation approaching, please contact us. SCC can formulate and implement a strategy to make your transaction a success.

Shareholder Communications Corporation

40 Exchange Place

New York, NY 10005

Phone: (212) 809-3600

Fax: (212) 809-2679

Contact:

W. Sam Chandoha

Proxy Solicitation Services

- Routine
- Special Elections
- Problems and Rescues

Information Agent Services

- Tender Offers
- Exchange Offers
- Convertible Security Redemptions
- Going Private Transactions
- Warrant Redemptions and Expirations

Shareholder List Management

- Small Shareholder Buyouts
- Lost Shareholder Research
- Postmerger Cleanups

Senator D'AMATO. Are you going to suggest some positive changes, then?

Mr. WOLLACK. Yes. That's coming up right now, Senator.

Senator D'AMATO. Good. I'm interested. I have to tell you something. You've touched on an area—again I want to commend my friend and colleague, Senator Dodd, for touching on this because it's obvious, Mr. Chairman, that this is an area that needs some reform.

I'm not quite certain how we do it. We don't want to kill investment opportunity, I know that. I know that's your strong feeling. But how do we protect the shareholder or the investor, the limited partner, and do it in a manner which still encourages capital formation.

I'm looking forward to some of your suggestions.

Mr. WOLLACK. I have a couple of suggestions in the remaining portion of my opening remarks and then I will be happy to take additional questions, Senator. I've thought long and hard about this.

You should know, Mr. Chairman, that if rollups are allowed to go on as they do now, there may be as much as \$10 to \$15 billion dollars of equity lost over the next couple or 3 years by the 8 million limited partners now in limited partnerships. Limited partners just like Mr. Rybicki and Ms. Hooker.

So what can Congress do, Senator, to end the victimization of limited partners? Plenty. Among the specific steps that should be taken are, first, protect the rights of the dissenters.

Where less than perhaps—if you can't get an 80-percent vote of the limited partners in favor of the transaction, meaning that there's overwhelming support for it, then dissenting limited partners should be given options. And those options should include the chance to be cashed out or to remain in their original investment or its substantial equivalent. That is the most important and fundamental reform that could be done.

The second thing that Congress could do is to correct the proxy process. For example, pay the brokers for yes and no votes or disallow such inducements altogether. Also in the proxy process, open up the rollup process to scrutiny by providing for earlier notification of limited partners. Some of these get filed in a quiet filing with the SEC and it will be 5, 6, 7 months before the limited partners know what's coming down the pike, and then they are required to vote in 20 or 30 days.

And, finally, establish clear guidelines for the cover letters from general partners, the accompanying fairness opinions and the proxy solicitor practices.

And a third area of focus for congressional action is to reform and improve the information flow to small investors. In this area I would recommend that the proxy be summarized in lay English. And the proxy should have, in this summary, not just a recitation of facts, of pros and cons. There should be a conclusionary statement as to the net effect of the proposed rollup on the limited partners, something that they can understand so they can make an intelligent vote.

Mr. Chairman, the second chart that I have up here illustrates that over a third of a million limited partners are at risk this year.

That's the last bar chart. These tions or those that have been and they're planning. That's 50 percent 50 percent more than the end you a sense of the cumulative effect rollups and why Congress needs

Mr. Chairman, I applaud you, for your efforts on behalf of protective rollups. It is time for this ex finally be brought to an end.

I respectfully urge you to act quickly into place.

[The complete prepared statement follows:]

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xploitation of limited partners to
quickly to put the needed reforms
ment of Richard G. Wollack fol-

Liquidity Fund

MANAGEMENT, INCORPORATED

1000 PINE LANE, SUITE 2000, FARMINGTON, CONNECTICUT 06030

WRITTEN TESTIMONY OF
RICHARD G. WOLLACK
CHAIRMAN OF LIQUIDITY FUND MANAGEMENT, INC.
BEFORE THE SECURITIES SUBCOMMITTEE
OF THE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
OF THE UNITED STATES SENATE
ON PUBLIC LIMITED PARTNERSHIP REORGANIZATION

FEBRUARY 27, 1991

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EXECUTIVE SUMMARY

The financial well-being of eight million small investors is at stake in the growing phenomenon of public limited partnership reorganizations, or what commonly are referred to as "roll-ups." More than 275,000 limited partnerships investors already have been caught up in roll-ups. It is expected that an additional 300,000 small investors will face the same prospect this year. And, to date, not one of these roll-ups has performed successfully. In fact, in 13 major roll-ups already undertaken, investors have been hit with an average decline of no less than 63 percent in the value of their equity, including a dramatic drop of 44 percent on the very first day of trading.

I would not be testifying today if the problem was that roll-ups were fairly executed and investors subsequently lost money due to normal market risks. But that is not the case. Rather, the problem is that the major roll-ups to date have been exceedingly abusive and unfair to limited partners. Who benefits from these roll-up deals if not the limited partners? Certainly, the general partners, who rake in millions of dollars in new fees and other costs, and their legion of investment bankers, lawyers and accountants, all of whom help put together the deals that line their own pockets at the expense of the limited partners, who stand by helplessly and watch their money vanish overnight.

In the roll-up process, there is no one looking out for the interests of the small investors who had put their money into limited partnerships. Quite simply, it is a process in which the general partners hold all the cards in what amounts to a deck stacked against the limited partners. Fundamental investor protections that are in place in traditional corporate transactions are entirely absent in limited partnership roll-ups. The rules and regulations which govern mergers and other similar corporate reorganizations do not account for the following major differences in roll-up transactions: (1) the extraordinarily complicated nature of the transaction; (2) the lack of investor sophistication; (3) changes in investment objectives; (4) the absence of independent directors who represent the interests of investors; and (5) "cram-downs" which prevent investors from "voting with their feet" (i.e., selling their shares in the open traded market).

For these reasons, exclusive reliance on the disclosure rules of federal securities laws to remedy the gross imbalance that exists between the general partners and limited partners is inherently flawed. While investors will benefit from a flow of more meaningful and independent information, additional structural and procedural safeguards must be put in place.

Among the specific steps that should be taken by Congress are the following:

- Protecting dissenters' rights in roll-ups where less than 80 percent of the limited partners vote in favor of the proposal. In such cases, dissenting limited partners should be given one of three options, including: (1) accepting the securities offered in the proposed reorganization or exchange offer; (2) remaining in the original constituent partnership and preserving their interest therein on the same terms and conditions as existed previously; or (3) redemption rights, as provided for through rulemaking by the Securities and Exchange Commission.

- Strengthening procedural and structural safeguards to correct the existing deficiencies that allow the general partners to have the upper hand. Among the suggestions here are: (1) either pay brokers for both "yes" and "no" votes or disallow the compensation inducement altogether; (2) establish an independent limited partners' review committee; (3) open up the roll-up process to scrutiny by providing for earlier notification to limited partners; (4) allow limited partners to actively communicate with one another about their position(s) on the proposal; (5) establish clear guidelines about what may and may not be included in the cover letter from the general partner to limited partners that accompanies the proxy; (6) establish clear guidelines for the rendering of fairness opinions; (7) prohibit third party endorsements; (8) require an independent count of the proxy votes; (9) prohibit the imposition of "super majority" provisions in the rolled-up entity; and (10) establish guidelines with respect to the conduct of proxy solicitation firms.

- Improving the flow of information so that small investors have the tools with which to make informed decisions from which they will benefit. In this area, it is recommended that the following information, set out in clear, concise lay English, be provided to limited partners: (1) the pros and cons of the proposal, as well as a statement of the net effect of the proposed roll-up on the original investment; (2) detailed charts illustrating detailed "before" and "after" fees and charges to be collected by the general partners; and (3) a statement about the actual performance of limited partnership roll-ups to date. Finally, general partners should be prohibited from using partnership funds to explore the feasibility of a roll-up or other restructuring unless the use of such funds is disclosed simultaneously to all limited partners.

I. INTRODUCTION

Mr. Chairman, I very much appreciate the opportunity to appear before the Subcommittee on Securities to discuss the issues and problems associated with the relatively new phenomenon of public limited partnership reorganizations, or what commonly are referred to as "roll-ups."¹

Mr. Chairman, you and your colleagues are to be commended for focusing attention on the very real and serious abuses associated with most limited partnership roll-ups.² At stake here is nothing less than the financial well-being of this country's eight million limited partners, hundreds of thousands of whom will be subject in the coming months to abusive roll-ups unless swift and meaningful federal action is taken.

And, make no mistake about it, the eight million investors who are at risk here are not "high rollers" who can shrug off losses and continue on when thousands of dollars are involved. Most limited partners are small investors. They are not market tycoons who have made a career or a game out of playing the stock market. They are average working men and women who hope to increase their assets by investing in what appears to be a relatively safe, profitable transaction that will end in a specified period of time. They place their faith in the general partners to take their money and to increase it. For them, a trail of devastation follows on the heels of a failed roll-up: Retirees who had worked hard and built up savings in the hope of a comfortable retirement face an uncertain and shaky financial future; parents who had responsibly put away money to finance the college education of their children must begin anew the long and frustrating process of building up those funds again -- assuming there remains time to do so; and still others lose faith altogether in the capital markets and are unlikely to ever again trust to them their savings.

¹ Richard G. Wollack is the Chairman of Liquidity Fund Management, Inc. The Liquidity Fund is a registered investment advisor which for ten years has assisted limited partners by matching buyers and sellers, and in creating liquidity in a secondary market for limited partnerships. In those ten years, Liquidity Fund has, on behalf of its investors, acquired over \$135 million of limited partner interests.

² While roll-ups traditionally are viewed as the merger or combination of two or more limited partnerships, a roll-up or other similar restructuring is in fact a broader phenomenon and can occur when the form or investment objective of even a single partnership is changed.

II. THE BREWING CRISIS IN ROLL-UPS

More than 275,000 limited partnership investors were caught up in 13 major roll-ups of non-traded public partnerships conducted through 1990. This year, an estimated 300,000 small investors in over 110 non-traded public limited partnerships now valued at \$2.7 billion are expected to be confronted with a roll-up proposal. How have limited partners fared in the roll-up process? A startling **100 percent** of these roll-ups to date have lost money for these investors, who have been hit with an average decline of no less than 63 percent in the value of their equity, including a dramatic drop of 44 percent on the very first day of trading.

Investors in rolled-up real estate limited partnerships, for example, have watched helplessly as an astounding **84 percent** in their equity has vanished. To date, there has not been a single -- not one -- roll-up of real estate limited partnerships that has performed successfully. (Although each and every one of these deals has lost money for its investors, general partners and their investment banking, legal and accounting associates have not suffered the same fate.) This abysmal performance of real estate limited partnership roll-ups makes oil and gas limited partnership roll-ups, where again there has not been a single success story, look good by comparison since investors there have watched their equity decline by "only" 35 percent.

Why is there such a drop in value when these roll-ups reach the public trading markets? The answer is surprisingly simple. When roll-ups are publicly traded, they are competing for the money of investors who are searching for stocks with growth and/or dividends, and preferably both. Roll-ups offer little of either -- and, as a result, their value plummets.

There is little growth prospect because the roll-up combines good and bad performers. The resulting product is a weak performer complete with many failing components. There is no prospect for meaningful dividends because the terms of the roll-up enable dividends (which might come from property sales or refinancing) to be reinvested, not distributed. Dividends that might come from the income of ongoing operations also are unlikely because of actions on the part of the general partners, including: taking out huge fees to organize the roll-up; reducing cash flow by increasing their equity position or taking cash in lieu of equity; propping up bad investments with good ones; and granting themselves hefty annual management fees.

Mr. Chairman, it would be one thing if the problem with limited partnership roll-ups was that they lost money for investors, since any investment can do that. The real problem is that the major roll-ups to date have been grossly unfair to limited partners. As James B. Cloonan, president of the American Association of Individual Investors

(AAII) so aptly summarized the problem: "So far, I have not found a 'roll-up' that was good for the limited partner investors."³ Even as the equity of small investors in such deals dwindled by over \$1.4 billions of dollars, the general partners made sure that their own pockets would be lined with as much as \$190 million in fees and other costs. Also profiting handsomely off of these deals are the legions of investment bankers, accountants, and attorneys, all of whom work on behalf of the general partners and yet are paid with the money of the limited partners. Everyone wins -- except the helpless limited partner, who is all but crushed in these deals.

III. LIMITED PARTNERSHIP INVESTMENTS AND ROLL-UPS: AN OVERVIEW

Mr. Chairman, general partners and other industry experts offer up fancy talk about liquidity, administrative economies of scale and assigned exchange values as a means of justifying a roll-up process unencumbered by investor safeguards. With a wink and a nod, they ask us not to tinker with a system that is "working." It is a system, they tell us, that is very complicated and in which success hinges on their ability to continue to operate under existing procedures. But they do not tell the whole story; they conveniently leave out the small investor perspective. Clearly what works for so well general partners is not working at all for limited partners. What follows then is a straight-forward explanation, from the investor perspective, of limited partnership investments and the roll-up process.

In a typical limited partnership, the average investor purchases a limited partnership interest for \$10,000. That investment, which is likely to represent a meaningful portion of the investor's net worth, is combined with the investments of several thousand other individual investors in the same partnership. The total amount invested is used by a general partner to purchase assets, typically in real estate or oil and gas properties, which then are managed by the general partner.

The primary economic reason for investing in a limited partnership is not to shelter income for tax purposes, but rather it is the expectation that in five to 10 years (the projected lifespan of a typical limited partnership), the properties involved will grow in value and be sold. The investors expect that the cash distributed from future property sales, combined with modest annual cash flow from operations, will result in the return

³ James B. Cloonan, editorial, *AAII Journal*, July 1990.

of their initial \$10,000 investment plus a profit.⁴ Importantly, it was not expected by these individuals that the money would be reinvested.

Of course, limited partners, like all other investors, assume general market risks -- whether in real estate or oil and gas. These investors are willing take such risks because they are secure in knowing that the contract they have with the general partner assures them that: (1) the general partner will earn no share of profits until the investors receive a return of their capital plus some profit; (2) the general partner receives reasonable annual management fees; and (3) the contract will not be changed. And again, they would get their money back when the assets are sold and the partnership dissolved.

All of those assumptions on the part of limited partnership investors fly out the window when a general partner proposes to roll-up the limited partnership interests -- that is, to combine, either through a merger, acquisition, or consolidation, two or more non-traded limited partnerships into one new investment vehicle, the interests of which then are traded on an exchange. It is only when a limited partnership investor receives a roll-up proxy in the mailbox that the realization sinks in that he or she may have been duped. When reading the proxy, the investor learns that the general partner is breaking his or her original promise to sell or refinance properties owned by the partnership and distribute the cash to investors in the promised timeframe. Instead, the general partner plans to combine what may be successful partnerships with many poorly performing limited partnerships to form a single limited partnership with a perpetual life. Rather than distributing the proceeds of any sale or refinancing to the limited partners, the proceeds are to be reinvested in the partnership to buy more properties or pay fees to the general partners. Investors never again have the absolute right to cash proceeds from the sale of assets previously owned by their partnership.

What follows is "walk through" of how a typical roll-up unfolds, from the perspective of a limited partner.

The story begins long before the limited partner knows that anything is afoot. Before the limited partner ever knows a roll-up is being contemplated, the general partner is quietly using the limited partners' assets to structure the roll-up, prepare the proxy (or prospectus) and file the appropriate documents with the Securities and Exchange Commission (S.E.C.), without revealing details of the transaction during the proxy registration process. Only after the document attains approval (which can take

⁴ In a limited partnership, one or more general partners manage the business while one or more limited partners contribute capital. Generally, limited partners have no right to participate in the management and operation of the partnership's business and assume no liability beyond the capital they have contributed. A limited partner is not, in any true sense, either a partner or a principal in the business of the partnership; rather, he or she is a passive investor. The relationship between the general and limited partner is a fiduciary one, similar to that existing between a corporate officer and shareholder.

anywhere from four to six months) does the limited partner get his or her first inkling of what is to come.

The limited partner receives a 250-300 page proxy (or in one recent instance, nearly 800 pages!) full of legalese and technical jargon explaining the new investment. Included in the proxy is a statement that an independent investment banker has determined that the roll-up is fair. Along with the proxy, the limited partnership investor will receive a short cover letter from the general partner explaining that the roll-up is a good deal. Based on this information, the limited partner is asked to make a decision to vote "yes" or "no" on the proposed deal.

The proxy is a complex document designed to meet the legal and technical requirements imposed by the S.E.C. All too often, it is understood only by the most sophisticated of investment analysts. Thus, when the limited partner sees the laudatory cover letter from the general partner -- the same person in whom the limited partner already has placed his or her trust -- he or she is steered in the direction of ignoring the indecipherable documents and simply voting "yes" for the roll-up. The limited partner also may be persuaded to vote "yes" due to a misplaced belief that the "independent" investment banker's "fairness" opinion is certifying that the roll-up is a good deal for the investors. What the limited partner does not understand is that the investment banker is required to accept all of the general partner's profitability assumptions without analysis or confirmation.

Those limited partners who solicit additional views on whether or not to vote for the proposal may reasonably be inclined to contact their broker who sold them the limited partnership. The limited partner again is likely to hear that the proposed roll-up is a good deal. What the limited partner does not know is that the broker receives a commission from the partnership for each "yes" vote, but receives nothing if there is a "no" vote.

After receiving the analysis from the investment banker, the general partner and the broker -- all of whom have a direct financial interest in seeing the deal go forward -- most limited partners vote "yes," particularly after they are called at home by proxy solicitors hired by the general partners who try to reinforce all these "facts." Even in the unlikely event that skeptical investors remain who want to oppose the roll-up, they may have as few as 30 days in which to mount what is an enormously complicated and costly task.

The first problem confronting limited partners opposing a roll-up is in getting the general partners to voluntarily provide a list of all fellow limited partners -- something the general partners often will not do once they know the limited partner's purpose. The second problem is that S.E.C. rules prohibit discussions with more than 10 limited partners without filing appropriate proxy documents with the S.E.C. -- all of which takes

time and tremendous expense to prepare. The third problem is that it is virtually impossible within the allotted 30 days or so, to hire legal and other analysts to complete a detailed review of the proxy and to disseminate the analysis to other limited partners, many of whom might have already voted "yes" by the time they receive the new information. Finally, since the average investor committed only \$10,000 to the limited partnership, no single investor represents a significant block of control and thus no one investor has enough at risk to justify paying for the analytical and legal talent to evaluate and fight the proposal.

It is true that limited partners theoretically have the opportunity to vote "no" on a proposed roll-up deal. But the general partners hold all the cards in what amounts to a stacked deck against the limited partners. Throughout the entire roll-up process, there is no one working on behalf of the limited partners or representing their interests. The information given to limited partners is presented by people with a vested interest in seeing the roll-up go forward -- people who are paid by the general partner to accomplish just such a goal. The information is presented in such a way that only the most sophisticated investment analyst is able to understand its full implications and there is almost no time allowed to organize any opposition. And, most importantly, even if an investor opposes the deal and votes "no," the roll-up will be "crammed-down" the throat of all limited partners involved if only a razor-thin majority of them are persuaded to go along with the deal.

Why are general partners desperate to maintain this gross imbalance in the roll-up process? It would appear to be because, while limited partnership investors often face financial ruin in the wake of a roll-up, general partners make out handsomely. The general partners -- the same people who organize the partnerships and owe a fiduciary duty to maximize profits for investors -- often reap extraordinary benefits in a roll-up. For example, in the 13 major roll-ups carried out to date, the general partners and related parties have paid themselves anywhere from \$140 million to \$275 million in cash or shares. This is a simple case of "bailing out" general partners from the pockets of limited partners who, for all intents and purposes, have no shot at a fair chance of profiting from the deal.

Further, most general partners emerge from a roll-up deal with a larger claim in, and control over, the new entity than was true in the original entity. For example, it is not uncommon in a roll-up for general partners to: (1) convert their interest, which was subordinate to the limited partners' interest, into immediate cash or a guaranteed right to future sales and refinancing proceeds; (2) increase their management fees and salaries and create new disposition/acquisition fees, which exceed any potential cost savings that could be generated by the roll-up; (3) change the vote required to oust management or make any other material changes from a majority vote of the limited partners to a "super-majority" vote requiring a two-thirds vote; (4) combine sound investment properties with properties experiencing difficulties, thereby protecting weaker properties from foreclosure and creating a broader base of assets from which to collect fees; or

(5) buy additional "discounted" shares in the aftermarket, furthering entrenching themselves.

IV. THE RIGHTS AND INTERESTS OF LIMITED PARTNERS ARE NOT ADEQUATELY PROTECTED IN A ROLL-UP

Limited partnership investments are unique and distinct from other corporate securities. Yet, under existing federal securities laws limited partnership roll-ups are treated the same as any other corporate restructuring. It should be recognized that there are far more dissimilarities than there are similarities between corporate mergers and limited partnership roll-ups. Fundamentally, the panoply of investor protections in place in corporate transactions are completely absent in limited partnerships roll-ups. The rules and regulations governing mergers and other similar corporate reorganizations do not account for the following major differences in limited partnership roll-up transactions:

Complicated nature of the transaction. Roll-ups are unlike many exchange transactions for which the federal securities laws were designed. In a traditional corporate reorganization, investors typically are asked to exchange one security for an already-existing traded security. The value of what they will receive has been established in the marketplace. For example, an investor with a security that currently is trading for \$10 is offered to exchange that security for another one that is trading at \$5. The investor simply would receive two shares of the new security to equal his or her original \$10 value. There would be no loss of equity. In the case of roll-ups, however, the decision is much more complicated because the investor must make a series of decisions without the benefit of adequate or meaningful information, including: (1) whether to sell the assets of the entity in which it has invested for an indeterminate price since he or she is receiving securities with no established market; (2) whether the division of the proceeds of the sale is being done fairly; (3) whether the assets of the entity in which it has an investment have been fairly valued in relation to the assets of not one or two other entities, but perhaps a dozen or more other limited partnerships that are being rolled-up; and (4) whether or not to acquire an interest in a new business enterprise which has no history and accept the security for which there is presently no established market.

Lack of investor sophistication. In a roll-up, an investor is asked to make a decision that only an investment banker or sophisticated analyst is capable of weighing in an intelligent and informed manner. Investors are voting to provide a firm underwriting of the new securities. Clearly, investment bankers are far more

knowledgeable than the average investor in the rolled-up deals. The mere disclosure of all material and relevant information relating to the security alone is not satisfactory. And, so-called "fairness" opinions are anything but when it comes to offering views on what is in the best interest of limited partnership investors.

Changes in investment objectives. Currently, roll-up proxies give little or no consideration to, or a description of, the investment strategy of the new entity. Investors should be made to understand that the strategy of the consolidation or merger of limited partnerships is to create an ongoing business such that their only "out" will be the sale of their stock for whatever value it might then have, while the original investment objective was to own and eventually dispose of the particular properties acquired.

No independent directors. In the roll-up process, there is no independent party that works on behalf of, and represents the interests of, limited partnership investors.

"Cram-downs." Since limited partnerships are not traded, when just a bare majority of limited partners are persuaded to go along with a proposed roll-up, those who oppose it have it "crammed-down" their throat because they are prevented from "voting with their feet" (i.e., selling in the open, traded market) to get out of the deal.

In short, the most fundamental elements of corporate securities that serve to protect the rights and interests of small investors in other types of restructurings are missing in limited partnership roll-ups. Simply, there are no checks and balances on the activities of general partners in the roll-up process. The only "check" that is present is the one the general partners write to themselves and their associates who help put the deal together.

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V.

A "DISCLOSURE ONLY" FIX IS NOT SUFFICIENT

For the reasons explained above, exclusive reliance on the disclosure rules of federal securities laws to remedy the gross imbalance that exists between the general partners and limited partners is inherently flawed. While the S.E.C. is doing what it can with its full disclosure authority to protect limited partner interests, the system is not working. While limited partners will benefit from a flow of more meaningful and independent information, concerns about the current inadequacy of disclosure account for a relatively small portion of the serious abuses associated with roll-ups. As indicated

above, the existing structure of roll-ups is inherently defective and unfair to small investors. No amount of disclosure will remedy these fundamental problems. Disclosure alone:

- Will not enable a financially unsophisticated investor to understand 250-300 page proxy statements, which are now filled with complex "legalese" and other boilerplate about the proposed transaction. Consider the case of one recent roll-up involving a massive proxy package which runs to roughly 800 pages.
- Will not offset the biased advice of brokers who are paid only for recruiting "yes" votes on the proposed roll-up.
- Will not shield limited partners from the high-pressure tactics of proxy solicitors who call them at home imploring them to send in the proxy marked "yes."
- Will not make the general partners' cover letter any more accurate or honest in tone about how it is the limited partners are likely to fare in the deal.
- Will not allow an investor in a "cram-down" roll-up to exercise a real choice about his or her investment.
- Will not release the gag now imposed on limited partners who want to join together in opposition to the roll-up -- without having to file a costly proxy.
- Will not provide limited partners with independent counsel who will review the merits of the transaction and make an honest recommendation.

Mr. Chairman, the recent Concord roll-up⁵ should put to rest any suggestions that the quick "fix" here is simply to improve disclosure. While investors in this proposed roll-up were given what analysts say was arguably the most thorough disclosure yet observed in these transactions, the deal they were offered (and ultimately accepted), according to these same analysts, was clearly one of worst. In the roll-up process, super-

⁵ In October 1990, the general partners of Concord Milestone Income Fund, L.P. and Concord Milestone Income Fund II, L.P. commenced solicitation of limited partners' consents to approve the merger of these two entities into a single, newly-created corporation, Milestone Properties, Inc. The transaction was approved by the limited partners in December 1990 and the entity is now listed for trading on the New York Stock Exchange. The two partnerships included in this transaction were formed between 1984 and 1987 for the purpose of investing in existing income-producing real estate. The partnerships raised \$72MM in equity capital which was invested in 13 properties.

majority voting provisions replaced the previous simple majority vote of limited partners; operating expenses rose by several hundred thousands of dollars; investor distributions declined by between 35-50 percent; general partners bestowed upon themselves a disproportionate equity share in the new entity; and the general partners made sure that management would be compensated handsomely, including a new (and previously prohibited) \$300,000 annual salary to the Chairman and CEO. While limited partners may have been duped into believing the Concord roll-up would be a good deal for them, the marketplace was not similarly fooled. On the very first day of trading, the shares plummeted a whopping 85 percent from their appraised value!

The acceptance of this transaction by investors illustrates what has been said by roll-up critics for some time: Disclosure alone does not give investors the tools needed to make the decision most in line with their own interests. Despite the failure of every single major real estate roll-up completed to date, roll-ups continue to be approved. Clearly, these transactions, which already have resulted in the loss of more than \$1.4 billion in investor equity, can be expected to continue in the absence of clear and meaningful guidelines which govern the structure of these investments and the manner in which they are sold.

VI. CURBING LIMITED PARTNERSHIP ROLL-UP ABUSES: A BLUEPRINT FOR FEDERAL LEGISLATIVE REFORM

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What can federal lawmakers do to spare the more than 300,000 small investors of the immediate danger they face in abusive roll-ups during 1991? Currently, the general partners who package these roll-up deals hold all the cards, including total control over the secretive structuring of the proposals and the setting of the rules and the timeframe for limited partner voting. What limited partners urgently need is the right to preserve their original investment and the restoration of their ability to make truly meaningful and informed decisions about their financial destiny.

Exactly what investment instruments and transactions should be subject to heightened scrutiny? The abuses associated with limited partnership and other similar restructurings (as defined earlier) occur when a publicly-offered, but non-traded, limited partnership has its fundamental promise of liquidation (within a reasonable timeframe) changed through a merger, exchange, combination or re-structuring which effectively transforms it into an infinite life, publicly-traded vehicle. Therefore, the original investment instrument in question may be defined as:

"Any limited partnership which: (1) is registered or reports under the Securities Act of 1933 or the Securities Exchange Act of 1934; and (2) does

not currently trade on any recognized national exchange (or in the future creates freely transferable units, whether or not traded)."

Similarly, the abusive roll-up process that should be subject to legislative action may be defined as:

"Any transaction which (1) forces, any limited partner to change his or her position from owning an interest in a finite-life partnership which requires the proceeds of any asset sale or refinancing to be distributed to the equity owners (thereby creating a "self-liquidating" vehicle) within the timeframe originally contemplated, to a position of owning an 'infinite life' vehicle (one which does not guarantee to non-consenting limited partners the distribution of sales proceeds, within a reasonable period of time, as originally promised, but may now reinvest such proceeds); or (2) where the terms of partnership control are changed from requiring a simple majority vote to where a 'greater than majority' vote of the limited partners is required to effect change;" or (3) where the original timing of when the investment is going to be liquidated is substantially lengthened."

Mr. Chairman, I respectfully recommend that any steps taken by Congress to accomplish this important end address three major areas in need of reform, including: (1) protecting dissenter rights; (2) strengthening procedural and structural safeguards; and (3) improving the flow of information. Specifically, I recommend that the steps discussed below be taken by Congress to strengthen the limited partnership protections of the federal securities laws.

Protecting Dissenter Rights. While the concept of dissenter rights is well established in corporate law, it is virtually nonexistent in limited partnership roll-ups and other similar restructuring related thereto. As a result, the vast majority of limited partners have no real choice but to agree to a proposed roll-up. Even if an investor opposes the deal and votes "no", the roll-up will be "cramped-down" the throat of everyone (including those who voted "no"), if a bare majority of limited partners are persuaded to go along with the deal. In order to tackle this abusive practice, Congress should amend the federal securities laws to allow for dissenter rights in the area of limited partnership roll-ups when less than 80 percent of the limited partners vote in favor of a roll-up⁶. This approach would still permit general partners to propose any

6 A threshold of 80 percent is recommended for the following reasons: (1) no abusive roll-up to date has achieved near an 80 percent "yes" vote; (2) if 80 percent of the limited partners vote "yes," there should be a presumption that it is fair deal; (3) general partners will be encouraged to structure their deals in a manner that is more fair to limited partners if they know that failing to achieve such a threshold will require them to provide other options to those limited partners who oppose the deal; and (4) it recognizes that it may not be economically beneficial to the limited or general partners if fewer than 20 percent of limited partners must be

and all forms of restructuring, so long as dissenting limited partners are given a meaningful option to preserve the equity and rights of their original limited partnership investment.

I respectfully urge that **the federal securities laws be amended** or the S.E.C. be directed to undertake rulemaking initiatives to provide limited partners the following options when faced with a roll-up or other restructuring proposal from the general partners:

- Accepting the securities offered in the proposed reorganization or exchange offer;
- Remaining in the original constituent partnership in which they are a partner and preserving their interest therein on the same terms and conditions as existed previously; or
- Dissenter redemption rights, the specifics of which would be provided for by the S.E.C. through rulemaking. Any such rulemaking initiative might provide for limited partners receiving compensation in either (a) a promissory note of the issuer with a principal amount equal to the appraised unit value of the recipients' interest in the original constituent partnership, secured by the principal assets of such original constituent partnership, and with a maturity of not more than five years and paying interest at not less than 120 percent of the applicable federal rate normally applied for the terms of the notes; (b) other seasoned publicly traded securities; (c) cash; or (d) some combination of a promissory note, seasoned securities or cash, at least in an amount equal to the appraised unit value of such partners' interest in his constituent partnership.

Strengthening Procedural and Structural Safeguards. While it would be an important and valuable improvement for small investors, the addition of dissenter rights alone will not remedy the deeply-rooted problems in the current roll-up process. For example, even if limited partners are shielded from "cram-downs," they would remain susceptible to other procedural and structural deficiencies that would still allow general partners to have the upper hand. Among the procedural and structural flaws most in need of correction by Congress are the following:

- Brokers should be paid for both "yes" and "no" votes, as opposed to just "yes" votes, as is now the current practice. Alternatively, no compensation

afforded dissenter rights.

should be allowed as an inducement for soliciting the votes of limited partners.

- An independent limited partner review committee should be permitted and authorized to use partnership funds to hire counsel, appraisers and advisors to analyze the transactions and negotiate with management. The committee also should be permitted to make recommendations to limited partners.
- The roll-up process should be opened up to limited partner scrutiny by: (a) requiring disclosure to limited partners of the proposed transaction at the time of the first proxy filing with the S.E.C.; and (b) requiring a 45-day "quiet period" between the effective date and distribution of the proxy and the point in time that proxy solicitation begins.
- An unlimited number of limited partners should be allowed to actively communicate with each other about their position(s) on the general partners' proxy. (Current law permits only 10 investors to communicate in such a manner.) Also, limited partners should have an absolute right to the timely provision of the list of all other limited partners. This could be accomplished through S.E.C. rulemaking to define "communication" for the purpose of limited partners facing roll-ups.
- The S.E.C. should be directed to promulgate rules clearly spelling out the parameters for all information to be contained in the covering letter from general partners. The S.E.C. rules should make clear that such letters are to be used for the sole purpose of a recitation of facts related to the proposal and not as a sales tool. Additionally, the rules should require that a statement, prominently placed, be included to the effect that the interests of the general partners may directly conflict with those of the limited partners.
- Firms which issue "fairness opinions" should be truly independent of general partners and base their assessment on the actual terms of the transaction with an obligation to independently verify all data and assumptions provided by the general partner. Firms that opine on the fairness of the transaction should not be allowed to have a financial stake in the outcome of the deal and should be required to offer an opinion on whether investors are economically better off staying in the original deal or under the roll-up. The opinion providers also should be required to set out and explain the valuation methodologies used to estimate trading value and justify why the deal is economically feasible.

- Prohibit third-party endorsements or editorial articles in support of the proposed roll-up paid for by the general partner out of partnership funds.
- Require an independent count of the proxy votes. All involved parties should have access to information about the status of the vote-counting process. (This could easily be accomplished if an independent review committee is established.)
- Prohibit the imposition of a "super-majority voting" provision in the subsequent rolled-up entity which would require a greater than majority vote for limited partners to effect changes.
- Finally, Congress should direct the S.E.C. to consider whether new guidelines should be established to govern the conduct of proxy solicitation firms. I recently received an announcement from one such firm which boasted of their ability to deliver consents in "the face of stiff opposition from limited partners, a barrage of bad press against the concept in general and the absence of brokers being paid for 'yes' votes." The firm was able to deliver a majority consent in connection with the roll-up of two limited partnerships by using what they referred to as a "variety of strategies, including one-on-one contact with investors, various types of follow up and reminder mailings as well as enlisting the participation of management for contact with key investors."

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Improving the Flow of Information. Control over almost all aspects of information about a proposed roll-up is one of the most powerful tools used to unfair advantage by general partners. Limited partners now are provided with very little in the way of data that is useful to the decision-making process of a typical non-expert small investor. Therefore, Congress should improve the flow of information to limited partners by requiring:

- A short summary of the proposed roll-up written in clear, concise *lay English* which discusses conclusions and is not just a recitation of facts. This non-technical overview should appear prominently in the first section of the proxy and include the following information: (a) the pros and cons of the proposal, as well as a conclusion of the net effect on the investment of the current and proposed structures; (b) illustrative numerical charts detailing "before" and "after" fees and charges to be collected by the general partner, including the projected outcome of a hypothetical liquidation of the limited partnership assets; and (c) a chart detailing the performance of all prior roll-ups.

PARTNERSHIP ROLL-UPS ARE NOT A SMALL ISSUE!

EXHIBITS

Abusive limited partnership roll-ups are not an insignificant issue, which may only affect a few voters. Rather, thousands of real people in each State/Congressional District are affected by the potential abuses.

LIMITED PARTNERS BY STATE*

State	Number of Limited Partners	Average Investment	State	Number of Limited Partners	Average Investment
ALASKA	26,790	\$ 9,556	MONTANA	32,210	\$ 8,415
ALABAMA	46,810	\$11,096	N. CAROLINA	116,520	\$12,268
ARKANSAS	24,300	\$11,315	N. DAKOTA	13,830	\$ 9,735
ARIZONA	130,210	\$11,311	N. ENGLAND	55,540	\$10,211
CALIFORNIA	1,541,910	\$10,285	NEW HAMP.	37,240	\$10,477
COLORADO	317,730	\$ 7,723	NEW JERSEY	232,320	\$11,300
CONNECTICUT	152,360	\$11,073	NEW MEXICO	50,400	\$ 9,825
WASH., D.C.	35,550	\$12,300	NEVADA	25,040	\$11,415
DELAWARE	102,860	\$ 5,952	NEW YORK	749,750	\$ 8,387
FLORIDA	447,920	\$12,322	OHIO	260,630	\$11,404
GEORGIA	89,500	\$11,836	OKLAHOMA	44,250	\$11,309
HAWAII	44,690	\$10,066	OREGON	99,250	\$ 9,650
IOWA	77,260	\$ 9,533	PENN.	253,940	\$11,287
IDAHO	22,560	\$10,007	RHODE IS.	26,260	\$10,525
ILLINOIS	321,520	\$12,080	S. CAROLINA	46,640	\$11,417
INDIANA	95,050	\$11,165	S. DAKOTA	23,410	\$ 9,772
KANSAS	83,620	\$ 9,688	TENNESSEE	73,000	\$10,801
KENTUCKY	40,760	\$11,916	TEXAS	327,440	\$11,145
LOUISIANA	48,630	\$11,816	UTAH	43,280	\$ 9,648
MASS.	273,750	\$ 9,708	VIRGINIA	197,060	\$ 9,865
MARYLAND	151,770	\$10,422	VERMONT	20,830	\$12,026
MAINE	18,320	\$10,098	WASHINGTON	229,250	\$ 8,855
MICHIGAN	317,270	\$10,119	WISCONSIN	131,150	\$ 9,580
MINNESOTA	233,650	\$ 8,601	W. VIRGINIA	20,090	\$13,296
MISSOURI	163,030	\$10,891	WYOMING	15,650	\$ 9,870
MISSISSIPPI	14,340	\$10,091	TOTAL	<u>7,948,560</u>	<u>\$10,259</u>

*This data is derived from a computer analysis of the Liquidity Fund mailing list of nearly 800,000 limited partners, approximately 10% of the total number of limited partners across the United States. We sorted our list geographically to determine the number of limited partners in each state. We then extrapolated each state's total by multiplying the count of limited partners on our list by a factor of 10 (since our list is 1/10 of the nationwide total).

A SHORT CASE STUDY

In 1978, Mr. and Mrs. Brown invested \$10,000 in McNeil Real Estate Fund VIII, a real estate limited partnership created by Robert A. McNeil Company, one of the largest sponsors of such investment programs. This investment capital, which represented perhaps 10-20% of the Browns' liquid net worth, along with the invested capital 5,500 other similar individual investors in the same fund, was used to purchase 21 commercial buildings in 12 states.

The primary economic reason for the Browns' investment was not a tax shelter, but the expectation that in five to seven years these properties would grow in value and be sold. It was hoped that enough cash would be distributed to them from the future property sales such that (in addition to some annual distributions from operations) they would be returned their \$10,000 plus an additional amount as profit.

The Browns were willing to accept some real estate risks, but they were secure in knowing that the limited partnership agreement they had with the general partner assured them that: (1) the general partner earned no share of profits until they achieved the above stated goals; (2) the general partner only received reasonable annual management fees; and (3) the partnership agreement would not be changed.

In 1986 Mr. McNeil decided he no longer wished to be in the general partner business and sold his company (and the general partner interests in all the McNeil partnerships) to the (now bankrupt) Southmark Company for \$58 million.

Shortly thereafter, Southmark decided to reject the planned orderly liquidation of the properties in the Browns' limited partnership and, instead, combine that successful partnership with more than 30 other limited partnerships. As part of the transaction valued in the aggregate at over \$400 million, Southmark would create a single, traded limited partnership, called National Realty L.P.

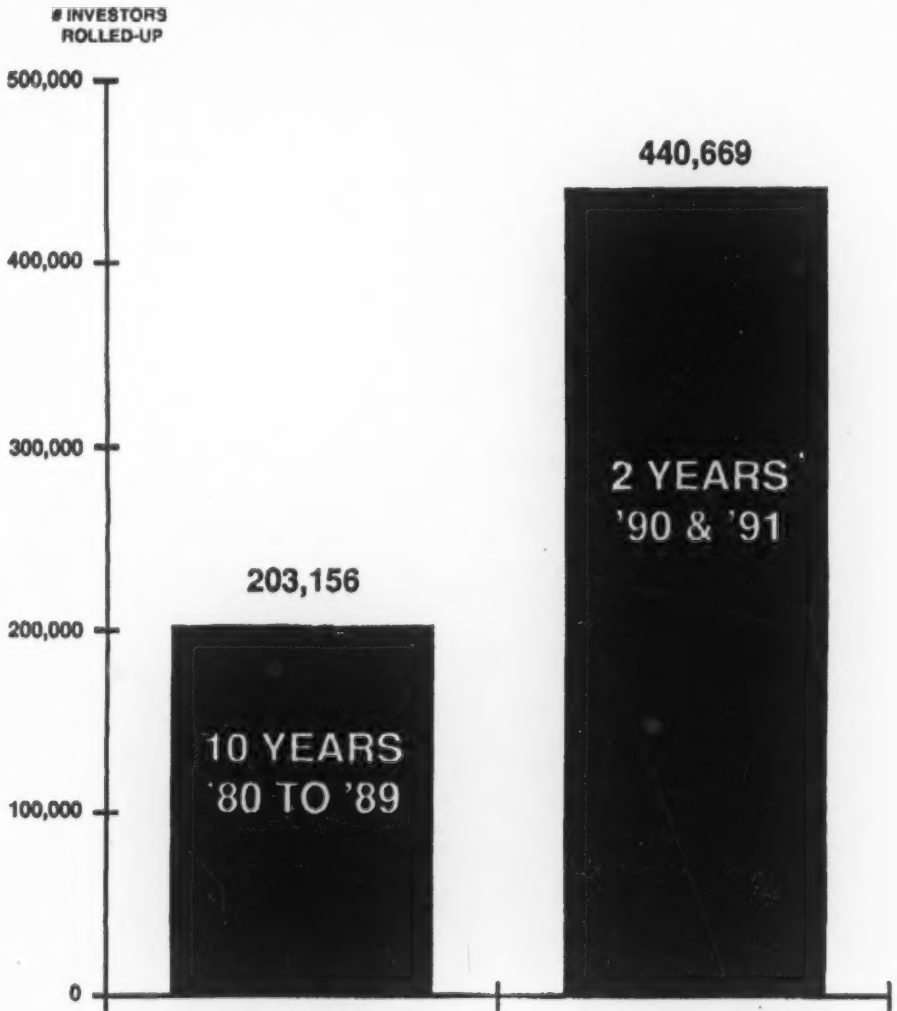
In 1987, the Browns received a huge proxy statement (273 pages), cover letter and 21 page marketing piece recommending they agree to this "rollup" because it would provide liquidity, administrative efficiencies, higher cash distributions, and greater financial flexibility.

The Browns were told that they would receive 391 shares of the new security valued at \$50 per share, based on a calculation of their pro rata share of the appraised value of the original limited partnership's real estate, or \$19,546 for their \$10,000 original investment. The Browns were excited to know that the investment had appreciated, since they only received \$3,640 in distributions since they invested in the limited partnership.

The Browns, unsure what to do were inclined to go along since it "sounded good" and was recommended by the general partner. Further, after talking with their broker, they weren't dissuaded from voting "yes" (The broker didn't mention that he received a commission for "yes" votes but not for "no" votes). The proxy passed in late summer 1987 and the National Realty shares began trading on October 8, 1987.

The 391 shares of the new rolled-up entity they received for their original investment, worth \$19,546 at that time, are now (2/21/91) worth \$5,278 - a decline of 73%. The shares, which were valued at \$50 at the time of the exchange, closed on the first day of trading at \$20. They currently are trading at \$14.50 per share.

**1990 - 1991 ROLL-UP ACTIVITY
50% GREATER THAN
ENTIRE 80'S DECADE**



* Includes projected 1991 roll ups

Source: Liquidity Fund

Senator DODD. Thank you, Mr. Wollack, very much for your testimony and that particular graph is the one that has startled me, considering the number of people who could be adversely affected here if we don't take some steps early on.

Mr. Errickson, we appreciate your being here. We had Mr. Stanger, who was going to be appearing, but we're happy you're here with us this morning and we're anxious to hear your testimony.

**STATEMENT OF LEE ERRICKSON, MANAGING DIRECTOR OF
ROBERT A. STANGER & CO. OF SHREWSBURY, NJ**

Mr. ERRICKSON. Mr. Chairman and members of the subcommittee, I thank you for the opportunity to appear before you this morning. I am Lee Errickson, managing director of Robert A. Stanger & Company, which is a publishing and research firm producing five monthly publications primarily oriented in investment partnerships and targeted for audiences that include investors and investment advisers in these product areas.

We have been following the difficulties with partnership reorganizations and rollups in the current genesis and have had articles in our publications since 1987, which have endeavored to advise investors how to analyze rollups and how to determine whether they're being treated equitably. And we remain greatly concerned about these issues.

Some of the things that we find particularly objectionable from our own analytical viewpoint are rollups that include extraordinary transaction costs, rollups that grant general partner interests equal to the present value of unearned fees, rollups that materially and on an unwarranted basis change the investment objectives, the immediate listing and trading of units when we think it might be better served to delay any listing or trading, unfair proxy practices that you have heard about which include harassment or giving the investor a limited period of time to vote, proxy prospectus documents without clear summaries and not providing a cash-out mechanism for dissidents.

However, we would also like to make certain comments in the spirit of what we've heard from the subcommittee. Whatever you do, you don't want to throw the babies out with the bathwater. And it is a very complex issue and the facts and circumstances of each rollup make it very difficult to have one form of legislation that would prevent all bad rollups without preventing rollups that may be good for investors as well.

And reasons that rollups may make sense include highly leveraged partnerships that were tax oriented, for which you need to pool the properties to cross collateralize and refinance them, and you may need to pool the administration of those partnerships to reduce the general and administrative cost charged by the general partners to those programs to administer them, all of which may serve to hold onto the properties to keep them from being repossessed by the banks and to prolong the life of the partnership awaiting a better turn in the asset cycle so that investors get a fair share down the line.

There are three areas that I would like to talk about in terms of clarifying comments. And again I say that I'm certainly not opposing reform. We're certainly for it. We're just trying to direct reform in some way that's totally beneficial.

Rollups in themselves in our opinion do not cause losses. Unfortunately, most of the constituent partnerships that have been rolled up have not fared very well prior to the rollup. The real estate markets trade securities at deep discounts to appraise value. That's nothing unique to either partnerships or to rollups.

If you look in the October 1990 edition of Realty Stock Review, which tracks corporations that hold real estate and are taxed in the form of REIT's, they are trading at an average discount to appraised value at the current time of 48 percent.

We looked at our own database of partnerships that have not been rolled up, that would be constituent partnerships prior to a rollup, effectively for which we had both trading price information in the secondary market and appraised values. And when we say "in the secondary market," we're referring to informal markets and excluding national exchanges such as the New York Stock Exchange, American Stock Exchange, and NASDAQ, in which most of the rolled up entities will trade subsequent to a rollup.

And we found that that universe of partnerships that we had for which we had both appraised values and secondary market values were trading at about a 44- to 45-percent discount to appraised value.

Appraisals actually take three components into account when they are done. One is to look at the replacement cost of a building if you're in real estate. The other is to look at comparables on similar buildings that have sold in a similar area and reasonably approximate timeframe, and to look at the income approach, which is a projection of the possible income that would be generated, discounted to a present value.

We are, in the real estate area, currently in what you might categorize as a depression. And the last time we had one, a real estate cycle like this, was in the mid-1970's. Which means when you're doing an appraisal, it's very difficult to find comparable values. There are not many buildings selling. There are not many buyers, and the market is very depressed and very inactive.

So appraisers have unfortunately been driven more to the income method. And I have never seen an appraisal that anticipates a decline in earnings in real estate. Therefore, there is bound to be currently a more significant gap in appraised values than what you might consider the real value of a building than you would generally have, which accelerates the problems of securities trading at more significant discounts to appraised values because the appraisals would be hard to realize if you were to attempt to liquidate those assets.

Again, another issue is whether general partners, by asking for additional fees, are in effect gouging the partnerships and being unfair to investors—and they certainly may be. However, we would like to add the following comments for balance on that.

Appendix F of the NASD code does not permit general partners to recover all of their administrative costs of managing a partnership. Infrastructure costs like rent, utilities, insurance, and salaries

of supervisory and executive personnel are not permitted to be charged. So they incur certain unreimbursed costs.

Like the limited partners, the general partners to a certain extent have been hurt by the depressed performance of the assets in which the partnerships are invested. General partners, admittedly, make a lot of money when they first issue the securities from the standpoint of front-end fees. They tend to make relatively little money in operating the partnerships. And if the partnerships were to perform successfully, that is the underlying assets were to perform successfully, they would make a great deal of money as might the investor on the liquidation of the assets.

The operating phase fees that are paid the general partners are generally subordinated to preferred returns to the investor. And since the assets are performing badly, the investor preferences are absorbing all the cash that's generated by partnerships and general partners are not getting a great deal of fees in the operating phase. And those investor preferences are cumulative. That is, if there's any arrearages, they haven't been able to be paid by partnership in a given year, they accumulate into future years and they are paid when they can be paid.

The net result is that when you do a rollup, the general partner is frequently seeking to change compensation, not necessarily to gouge the partnership, but in light of the current real estate performance, to get a compensation structure so he can get an equitable amount of compensation to manage the affairs of the partnership. And again, I'm not trying to paint him as a glorified person. He made a lot of money on the front end. He entered into this transaction knowingly and willfully, but very few people mind the store very well if they are not getting paid to do it.

So if you are going to bring in a new GP or even if you're going to expect an existing GP to properly manage the affairs of the partnership, you may live with the fact that they're going to look for additional fees on a reorganization.

Again, on the cramdown theory, and again let's define what it is. A cramdown, where a majority vote may cause minority partners to be forced to accept the rolled up entity and to accept the transaction. Again, there have been a few suggestions as to alternatives that I've heard. And practically—academically, I like those suggestions but practically there are difficulties there.

One is the dissenter rights issue of simply cashing out the dissenting shareholders on the basis of an appraisal. The fact is, the type of reorganizations that we're talking about involve typically highly leveraged transactions where those constituent partnerships in the rolled up entity have no cash reserves, they're not throwing off cash, and there isn't cash resources to pay dissenting shareholders out on an appraised basis.

[The complete prepared statement of Robert A. Stanger follows:]



General partners should be prohibited from using partnership funds to explore the feasibility of a roll-up or other restructuring, unless such activity is disclosed simultaneously to all limited partners.

VII. CONCLUSION

Mr. Chairman, the roll-up process, which is riddled with fundamental flaws, is in urgent need of an overhaul. Simply relying on disclosure is wholly inadequate to protect small investors facing limited partnership roll-ups. The hundreds of thousands of limited partnership investors who are immediately imperiled today are relying on Congress to strengthen the federal securities laws with supplemental safeguards, including dissenter rights and other procedural and structural reforms. I respectfully urge you to act quickly to put such reforms in place.

Mr. Chairman, I applaud you, your colleagues and your staffs for your efforts and concerns on behalf of protecting limited partners from abusive roll-ups and look forward to working with you, your staffs and other interested parties as the important process of developing limited partnership roll-up reforms is undertaken.

I am pleased to add my voice to a host of organizations representing the securities and partnership industries, such as the Coalition for Publicly-Traded Partnerships, the Real Estate Investment Association, the International Association for Financial Planning, and investor organizations such as the American Association of Individual Investors and the American Association of Limited Partners, all of which have recognized the pressing need for action to end the systematic victimization of America's eight million limited partnership investors. Thank you.

- Roll-Up Performance -

Comparison of Exchange Value and Closing Prices
1st Day, 90 Days, 120 Days†, Current Market Price

												Current [1/31/91] Mid. Price	
	Symbol	First Trade Date	Exchange Value \$	First Day Close		30 Day Close		90 Day Close		120 Day Close			% Change
				\$	% Change	\$	% Change	\$	% Change	\$	% Change	\$	
Real Estate Roll-Ups													
American Real Estate Partners	ACP	7/23/87	20.00	18.38	-18.1%	18.13	-19.4%	14.25	-28.8%	18.13	-19.4%	8.13	-68.4%
Continental Group, Inc.	CEQ	8/28/87	10.00	8.88	-11.2%	8.13	-18.8%	5.88	-41.3%	4.88	-51.3%	8.31	-68.8%
Hallwood Realty Partners††	HRV	11/2/90	30.00	8.50	-78.3%	5.75	-80.8%	4.50	-85.0%	n/a	n/a	4.63	-84.8%
INE/Bank Atlantic Debentures	*	8/1/88	50.00	24.00	-52.0%	20.00	-60.0%	18.00	-64.0%	18.00	-68.0%	18.00	-68.0%
National Realty, LP	NLP	10/8/87	200.00	80.00	-60.0%	80.00	-60.0%	67.50	-66.3%	72.50	-63.8%	7.38	-96.3%
Southwest Realty	SWL	2/8/83	20.00 **	13.80	-32.0%	13.35	-33.3%	13.40	-33.0%	13.70	-31.5%	1.38	-83.1%
Milwaukee Properties, Inc.	MP1	1/30/81	13.83 ***	3.87	-72.0%	n/a	n/a	n/a	n/a	n/a	n/a	3.80	-74.7%
Average Decline Real Estate Roll-Ups					-49.1%		-48.7%		-53.0%		-46.8%		-63.8%
Oil/Gas Roll-Ups													
Calton Consolidated Partners LP	CCLPZ	12/19/88	10.00	2.50	-75.0%	3.25	-67.5%	3.50	-65.0%	3.00	-70.0%	1.44	-88.8%
Hallwood Energy Partners****	HEP	8/11/80	15.00	9.38	-37.5%	9.50	-36.7%	9.25	-38.3%	8.63	-35.8%	9.00	-40.0%
Kelley Oil & Gas Partners	KLY	1/24/88	20.00	12.13	-39.4%	11.50	-42.5%	9.75	-51.3%	10.63	-46.9%	16.50	-17.8%
Mission Resource Partners LP	MRP	4/18/88	10.00	6.13	-38.7%	7.50	-25.0%	6.63	-33.8%	6.63	-33.8%	8.75	-12.5%
Parter & Purley Development LP	PDP	12/22/87	20.00	14.00	-30.0%	17.13	-14.4%	15.63	-21.9%	15.13	-24.4%	18.75	-21.3%
Sanson Energy Co., LP	SAM	1/18/88	20.00	15.13	-24.4%	13.88	-30.8%	15.83	-21.9%	14.13	-29.4%	13.63	-31.9%
Average Decline Oil/Gas Roll-Ups					-36.8%		-36.1%		-38.7%		-40.0%		-34.8%
Equipment Leasing Roll-Ups													
PLM International Inc.	PLM	2/3/88	15.00	8.38	-44.1%	7.38	-50.8%	8.25	-45.0%	8.38	-44.2%	4.88	-67.9%
Average Decline All Roll-Ups					-43.8%		-43.1%		-48.8%		-37.8%		-61.5%

* approximation of trading level of BankAtlantic debentures

** Includes price of Southwest Realty warrants issued in exchange after June warrant for every 8 shares issued.

*** Share prices are rounded to arrive at one share price for both common and preferred stock issued in the exchange.

**** Liquidity was created from the roll-up of entities which were both traded and non-traded prior to the transaction.

† 30, 90, and 120 day closing prices are based on calendar days rather than working days (if date falls on a weekend or holiday, price used is the next day's price).

†† Hallwood Realty was valued 80% from appraised value to arrive at exchange value. Exchange value noted here represents actual appraised value before 80% haircut.

INFORMATION SOURCES: ROBERT STAMER, OFFERING PROSPECTUS, AND STANDARD & POOR'S DAILY STOCK PRICE RECORDS

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Robert A. Stanger
Chairman of the Board

Testimony of Robert A. Stanger
Chairman

Robert A. Stanger & Co.
Before Hearings of the Subcommittee on Securities
of the Senate Committee on Banking, Housing and Urban Affairs
Delivered, Wednesday, February 27, 1991

Chairman Dodd and members of the Subcommittee, thank you for the opportunity to appear before you this morning. I am Robert Stanger, Chairman of Robert A. Stanger & Co. Since its formation in 1978, my firm has been the major source of publishing and research for investment partnership products and markets. Our monthly publications include *Stanger's Investment Advisor*, *Stanger's Partnership Watch*, *The Stanger Report*, *The Stanger Review* and *Selling Mutual Funds*. The primary audience of our publications is comprised of investors, financial planners or other professionals who sell securities and provide investment advice and sponsors of limited partnership security offerings.

The topic of today is partnership reorganizations, or "roll-ups". Let me provide you with some background information on partnership reorganizations and some of our viewpoints on the subject.

Background on Partnerships and Reorganizations

\$97 billion was raised in publicly registered limited partnerships and \$50 billion in privately offered limited partnerships from 1970 to the present, of which \$136 billion was raised since 1980.

Partnerships have a number of favorable intrinsic features as an investment vehicle: the pass-through of income or loss with no tax at the entity level; the flexibility with which the partnership's activities may be structured; the investment performance of typical partnership assets which is counter cyclical to financial assets. Partnerships for the most part invest in "hard assets" (real estate, oil & gas, equipment) which balance a financial asset portfolio (stocks and bonds) over business, interest rate and inflation cycles.

Investment partnerships designed for individual (non-institutional) investors have been widely criticized in the press recently. Much criticism is primarily caused by poor investment performance of leveraged transactions designed for tax write-offs (now obsolete) which are suffocating under excessive debt service obligations. In addition, the backbone industries of investment partnerships -- real estate and oil & gas -- are industries in adverse economic cycles and are experiencing adverse external influences, namely severely overbuilt real estate markets and instability in oil markets caused by the Persian Gulf war. However, investment partnerships are substantial components of the "alternative" investment portfolios of pension funds and other institutions and are equally valid additions to individual portfolios as well over the long term.

The troubled asset markets and poor operating performance of partnerships have both curtailed current fundraising for new issues of partnerships and simultaneously spawned interest in partnership reorganizations. Reorganizations may provide an opportunity to reduce costs to administer partnership assets and run operations, reduce debt costs or provide the ability to borrow by creating a pooled base of assets, or improve operating results by replacing the existing general partner with one who brings better skills to the task of managing the affairs of the partnership. Preventing reorganizations by legislation or regulation does not appear wise at this time.

Partnership reorganizations include a number of different types of transactions, including most commonly:

- o A merger ("roll-up") of constituent partnerships of a single general partner where partnership interests are exchanged for units of a surviving partnership or corporation and the constituent partnerships are liquidated. The primary business purposes of a roll-up are to increase the diversification of limited partners' investments, to reduce the cost of administering the partnership, to facilitate the refinancing of partnership assets through the pooling and cross-collateralization of loans, and to make permanent and economic the management of assets (which is a benefit to the general partner). Listing the security of the

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INVESTMENT STRATEGY

Analyzing Real Estate Roll-Ups

Should you vote "yes" to have your real estate partnership included in a "roll-up" (the combining of several programs into a tradable master limited partnership, or MLP)? Here's rule No. 1: Compare the cash distributions you receive from your existing

partnership to the cash distributions you'll receive from the new MLP. If your current cash yield drops, the "economics" of the roll-up are probably against you. But, you may decide to vote "yes" anyway to obtain the diversification, operating flexibility, and

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liquidity MLPs offer.

Rule No. 2: Look at the pro forma financial statements of the new MLP to see if the new roll-up portfolio is generating sufficient current yield to support your exchange value. If the yield on the new MLP is below the market yield on other real estate equities, expect the value of your roll-up units to trade down in the secondary market.

BACKGROUND

The concept of combining existing untraded partnerships into a tradable MLP originated in the oil patch and is now taking hold in real estate. Recently, Integrated Resources concluded a roll-up of 13 partnerships with a net equity value of \$300 million. Centennial completed a \$266-million roll-up of old partnerships (into corporate form). And, Southmark is currently rolling up 39 partnerships worth over \$470 million.

To create a roll-up, the value of each untraded partnership must first be estimated. Properties are appraised, partnership debt (mostly mortgages) is subtracted, and other values (cash, receivables, payables, etc.) are added to determine each untraded partnership's "exchange value." Next, the exchange

value of each partnership to be "rolled-up" is added to get the total exchange value. The general partner is assigned his share, and each untraded partnership's exchange value is divided into new MLP units with an arbitrary value — say \$10 or \$20. Finally, investors are asked to exchange their untraded partnership interests for roll-up interests of equal value.

KNOWING WHEN TO VOTE "YES"

To judge the merits of an exchange offer, compare the "advertised" cash distribution you'll receive from the roll-up versus the cash distribution you currently receive from your untraded partnership. Start by calculating the cash distributions you'll receive from the new roll-up. Multiply the "advertised" distribution per unit (found in the exchange offer document) by the number of new MLP units you'll receive. The number of new MLP units you'll receive per \$10,000 invested in each untraded partnership is listed in an Exchange Value table. (Table I presents the table for a recent roll-up of Integrated Resources' partnerships into American Real Estate Partners.)

If your cash distributions from the roll-up fall

Table I
EXCHANGE VALUE TABLE FOR AMERICAN REAL ESTATE PARTNERS L.P.

Partnership	Exchange Value	Portion of Exchange Value Allocable to Investors	Portion of Exchange Value Allocable to General Partners	Units to be Distributed to Investors	Units to be Distributed to General Partners	Exchange Value Received by Investors per \$10,000 Original Investment	Number Units Distributed to Investors per \$10,000 Original Investment
I	\$ 7,515,000	\$ 6,798,028	\$ 716,972	339,901	35,849	\$ 7,780	389
II	7,842,000	7,556,318	285,682	377,816	14,284	4,440	222
III	16,209,000	14,775,837	1,433,163	738,792	71,658	6,640	332
IV	10,062,000	9,192,930	869,070	459,647	43,453	6,440	322
V	15,054,000	14,052,162	1,001,838	702,608	50,092	7,060	353
VI	25,497,000	23,953,969	1,543,031	1,197,698	77,152	8,202	401
VII	24,015,000	21,651,141	2,363,859	1,082,957	118,193	7,240	362
VIII	35,736,000	32,336,506	3,399,494	1,616,825	169,975	5,940	297
IX	47,208,000	41,787,538	5,420,462	2,089,377	271,023	6,440	322
X	57,729,000	52,067,954	5,661,046	2,603,398	283,052	7,300	365
XI	32,631,000	29,253,779	3,377,221	1,462,689	168,861	9,080	454
82	10,536,000	8,975,104	1,560,896	448,755	78,045	7,640	382
83	9,966,000	9,260,530	705,470	463,027	35,273	7,240	362
TOTAL	\$300,000,000	\$271,661,796	\$28,338,204	13,583,090	1,416,910		

significantly below the cash flow you're receiving from your existing partnership, you're probably taking it on the chin economically.

You may choose to roll with the punch if you think the benefits of owning an MLP outweigh the economic cost. Here are the key pluses.

- **Liquidity** — The new MLP units are traded on major exchanges; so, investors can liquidate positions they were formally locked into. (Untraded partnerships are sold in thin, unregulated secondary markets; and, you usually can't get a fair price.)
- **Diversification** — By combining properties from several partnerships, the roll-up creates geographical and property diversification which provide a more secure cash flow stream.
- **Financial Flexibility** — The roll-up's larger asset base provides better access to capital markets. MLPs can fund expansion with the issuance of additional units or debt more easily than a smaller, untraded partnership.
- **Economies of Scale** — Operating efficiencies are achieved in the larger MLP.
- **Growth** — A roll-up MLP can retain cash from property sales and reinvest in additional properties to build the portfolio. The typical untraded partnership is a liquidating entity.

Even if the roll-up passes the cash flow test, you should consider the key negatives before voting "Yes." Among them:

- **Stock Market Asset Pricing** — Your interests in the roll-up will be valued by the stock market at a discount. So, if you intend to liquidate, you will probably realize less than full asset value.
- **Short-Term "Liquidity Penalty"** — Typically, when an untraded partnership becomes liquid, holders of existing units seek to liquidate formerly illiquid positions. As this pent-up selling pressure releases, the market value of a roll-up can decline significantly in the initial aftermarket.
- **Changed Business Plan** — The old partnership probably fits your investment objectives — now, the roll-up changes the game. The sponsor can introduce a new business plan (liquidation and reinvestment, new property types, allowable leverage, etc.) which differs from your original intent.
- **Loss of Tax Benefits** — Because the roll-up is considered a "new" investment, investors in older partnerships lose the advantage of accelerated depreciation and the use of any passive

losses. If the old partnerships were not rolled up, passive losses would be allowed subject to a 4-year phase-out.

- **General Partner's Interest Accelerated** — The new MLP gives the GP an interest in cash flow side-by-side with investors. Usually, in the untraded partnerships, the GP receives his fees *after* investors receive a "preferential" return.
- **Transaction Costs** — You pay substantial transaction costs to create the new entity. Broker dealer commission, property appraisal, printing and administration costs can equal 15% of your equity in the roll-up.

Here's the bad news: You'll probably have to go along with the exchange even if you don't want to. The vast majority of partners inevitably vote "for" the roll-up. If over 50% of the interests in the existing partnership you're in vote for the roll-up, you will be rolled up whether you like it or not.

HOW TO EVALUATE THE MARKET VALUE OF ROLL-UP UNITS

Rule No. 2 says you should look at the portfolio's cash flow to be sure the exchange value is realistic. The "exchange value" has been estimated and is not the result of a market transaction. You need to know the price at which the roll-up units are likely to trade in the aftermarket.

You want to judge portfolio value based on the portfolio's earning power, or cash-generating ability. Use the roll-up's pro forma financials to calculate three key indicators on the new MLP's portfolio: 1) free-and-clear capitalization rate; 2) current yield on equity; and 3) the percent of projected cash distributions earned. Table II on the next page provides an example for American Real Estate Partners.

- **Free-and-Clear Capitalization Rate** — The current yield on MLP assets. Start by determining the total capitalization of the roll-up. Add total exchange value (\$300 million in our example) to total debt (\$300.8 million) to get total capitalization (\$600.8 million).

Now go to the pro forma statement of operations and subtract general and administrative expenses, management fees and other property operating expenses from revenues to arrive at the net operating income (NOI) for the roll-up portfolio. (Exclude any earnings from the sale of

properties.) In our example, the exchange portfolio is generating \$58 million per year before debt service.

Net operating income divided by total capitalization equals the free-and-clear cap rate — 9.7% in our roll-up. The higher the free-and-clear cap rate, the better the health of the MLP.

- **Current Yield on Equity** — The current cash earned by MLP equity. Subtract interest expense (\$28.2 million) from NOI (\$58.3 million) to arrive at NOI after interest expense (\$30 million). Then divide NOI after interest expense by total exchange value (\$300 million) to get the yield on equity (10.0% in our example). Compare the earnings of your roll-up with earnings of other real estate equities. If your roll-up returns less than what other real estate equities earn, expect your new units to trade down in the aftermarket.
- **Percent of Cash Distributions Earned** — The percent of "advertised" distributions earned by the MLP. The exchange document will indicate the advertised distributions per unit. In our example, the advertised yield was \$2 per \$20 unit, or 10%. Divide the advertised yield (10.0%) by the current yield on equity (10.0%) to get percent of cash distributions earned. If the yield on equity is below the advertised distribution, the MLP is not currently generating sufficient cash to make the distribution. You'll need to ask how this gap will be overcome.

Calculating these three key measures on the roll-up portfolio gives you the knowledge you need to guess the MLP's price in the aftermarket. One

Table II

AMERICAN REAL ESTATE PARTNERS L.P.

1) Total Exchange Value	\$ 300.0
2) Total Debt	300.8
3) Total Capitalization	\$ 600.8
4) Gross Revenue	\$ 59.9
5) Less: Operating Expenses	1.6
6) NOI Before Interest Expense	58.3
7) Less: Interest Expenses	28.2
8) NOI After Interest Expense	\$ 30.1
9) Free-and-Clear Capitalization Rate (#6 ÷ #3)	9.7%
10) Current Yield on Equity (#8 ÷ #1)	10.0%
11) Projected Cash Distribution as % of Unit Price	10.0%
12) Percent of Cash Distributions Earned (#10 ÷ #11)	100.0%

hard reality: No matter how strong the earnings of the new MLP portfolio, your units will trade down in the aftermarket. The reason: Sellers far outnumber buyers in initial roll-up aftermarkets.

Using Rule No. 2 to assess the likely "market" value of the roll-up gives you another advantage: You know when to play in the secondary market. Should the price of the new units trade down below the "fair market value" you've calculated, you'll be ready to buy up the "cheap" units in the aftermarket. ■

REAL ESTATE PARTNERSHIPS

Investing In Hotels

Investors are scrambling to get into hotel deals before the "no vacancy" sign goes up on subscriptions. Why? The hotel industry has historically increased room rental rates faster than inflation. Also, hotel properties offer high current yield.

In addition, "value added" management can enhance return by (a) increasing revenues from non-rent sources (restaurants, gift shops, etc.) and (b) increasing hotel occupancy (marketing the property). For instance, a 5% increase per year in hotel

occupancy can increase investment returns by 25%.

But, hotel investing is no vacation. Hotels are among the most volatile real estate investments. Rooms must be re-rented daily, making occupancy rates rapidly vulnerable to economic downturns. The industry is highly competitive with numerous national chains and local hotels struggling to fill distinct market niches. Also, cost control and intensive management are vital to hotel operating profit margins.

surviving entity for trading may also provide investors with a more active market for their interests.

- o A change of general partner. A new asset manager acquires the original general partner's interests in the limited partnership, and the new asset manager is approved by vote of the limited partners. The new manager's compensation may be changed from the pre-existing agreements. The partnerships may or may not be rolled up at the time the manager is selected. Generally, the new manager is expected to exercise better management over partnership assets than the former general partner or to be in better financial condition to exercise the fiduciary role.
- o A partnership may be converted to a corporation -- usually a real estate investment trust (REIT), or a "C" corporation where non-real estate assets are involved. Conversion to a corporation may save the investor time and money in his or her tax preparation by eliminating the K-1, and corporate securities currently sell at higher market prices than partnership securities representing the same assets.

One of the problems in the process of reorganization is clearance of the prospectus/proxy by federal and state securities commissions. Attorneys uniformly advise clients to list the resulting Securities for trading to qualify for an exemption from the state Blue Sky regulations. Many of the so-called "merit" states have taken a negative view of reorganizations disallowing any change in compensation even when a new general partner or asset manager is involved. We believe most general partners who reorganize would prefer not to have to establish trading markets for resulting securities, at least in the short run.

Partnership interests were generally not sold to the investor originally with the intention of establishing a trading market and for sound reasons. Trading markets do not favor partnership securities, or "liquidating" entities, and price such securities lower than corporate securities. Further, the original investment objective was usually long term growth by holding the asset, rather than subjecting the investment to the inevitable swings of securities markets.

Perhaps one resolution of the current controversy over reorganizations is to find a way to allow the transaction but remove or substantially delay the necessity to trade the resulting securities.

It is the position of Robert A. Stanger & Co. that (i) each partnership reorganization is unique and distinct, (ii) generalizations are hard to make and (iii) reorganization is not

intrinsically good or evil. We have attempted to provide analytical tools with which an investor can assess the merits of these transactions. In the Appendix, I have included numerous articles concerning our methodology to grade partnership reorganizations. We take into account changes in general partner compensation, changes in the voting rights of limited partners, changes in the holding period or other investment objectives and many other factors. These factors are weighted to reflect our judgment which is expressed in detail in the Appendix.

However, we also appreciate the opportunity to discuss certain other issues which we understand have been brought up in the context of prospective legislation and which have been, in our opinion, misstated or misunderstood. Many aspects of recent reorganizations are objectionable, but many myths about reorganizations are receiving currency in the popular press and in the halls of Congress which are addressed herein.

Roll-ups Cause Losses

We agree partnership investments frequently trade at deep discounts to the original investment amount and to appraised value. However, trading prices at discounts to appraised values are neither unique to roll-ups nor caused by them. In the October, 1990 edition of Realty Stock Review, discounts to asset values were calculated for the universe of equity REIT's and real estate master limited partnerships ("MLP's", or publicly traded partnerships called "PTP's"). The average REIT sold at a 48.1% discount to appraised value. The average MLP traded at a 58.9% discount to appraised value. The figures show two realities. One is that real estate securities in general trade at significant discounts to appraised value. Also, partnership securities trade below comparable REIT securities and at larger discounts to appraised value.

So-called untraded publicly registered partnership securities do trade in the "secondary market" (defined as a trading market other than NYSE, AMEX or NASDAQ). Often partnerships that are merged were trading in the secondary market prior to the roll-up.

To illustrate prices in the secondary market for real estate partnership securities, the table below shows all 56 partnerships for which we have both appraised values and trading prices and which have not been rolled up. The average discount from appraised value is 44.5% and the range is a discount of 13.3% to a discount of 77.7%.

TABLE 1

Secondary Market Discount to Appraised Value

Partnership	Original Price Per Unit	Appraised Value/Unit	Transaction Price Per Unit		Appraisal to Mid Price
			2 Mo. Ended 11/30/90		
			High	Low	
Angeles Income 3	500	527	130	120	76.3%
Angeles Income 4	500	583	155	105	77.7%
Angeles Income 5	1,000	1,018	271	271	73.4%
Angeles Income 6	1,000	1,000	350	350	65.0%
Balcor Col Stor 85	250	295	140	140	52.5%
Balcor Col Stor 86	250	268	155	125	47.8%
Balcor EQPSM 1-TE	500	230	224	175	13.3%
Balcor EQPSM 2-TE	250	222	97	90	57.8%
Balcor EQPSM 2-TE	250	203	90	90	55.7%
Balcor EQPSM 3-TE	250	260	126	126	51.6%
Balcor EQPSM 3-TE	250	235	109	104	54.8%
Balcor EQPSM 4-TE	250	260	110	110	57.7%
DW Realty Inc 1	1,000	1,100	525	525	52.3%
DW Realty Inc 2	1,000	1,075	580	480	50.6%
Hutton Condo 3	500	357	88	88	75.4%
Hutton Condo 4	500	356	176	176	50.6%
Hutton GSA Comm 3	500	318	80	80	74.7%
Insured Income 81	500	507	469	409	13.4%
Insured Income 82	500	525	446	425	17.0%
Insured Income 83	500	510	450	414	15.3%
Insured Income 84	500	523	490	404	14.5%
Insured Income 85	500	513	482	408	13.3%
Insured Income 86	1,000	1,020	855	844	16.7%
JRB Income 2	1,000	279	109	109	61.0%
JRB Income 5	1,000	923	655	540	35.3%
JRB Income 6	1,000	1,632	840	815	49.3%
JRB Income 7	1,000	877	460	460	59.1%
JRB Income 8	1,000	895	500	425	43.1%
JRB Income 10	1,000	1,180	700	622	60.6%
JRB Income 11	1,000	1,100	450	450	33.5%
JRB Income 12	1,000	1,009	600	548	29.1%
JRB Inc. Mtg 1	1,000	635	250	250	52.7%
JRB Inc. Mtg 2	1,000	1,040	715	669	33.5%
Erupp Ins. Plus 2	20	20	14	14	29.1%
RLH Income	1,000	580	275	275	52.7%
RLH Income 2	1,000	629	325	325	48.3%
RLH Income 3	1,000	570	350	260	46.5%
RLH Income 4	1,000	926	440	410	34.1%
RLH Income 5	1,000	945	540	500	45.0%
RLH Income 6	1,000	926	730	670	24.4%
FaineWebber Eq. 1	50	45	18	18	60.0%

PS Partners 2	500	702	169	189	73.1%
PS Properties 7	500	502	675	380	16.8%
PS Properties 8	500	566	450	364	28.1%
PS Properties 9	500	489	468	390	12.3%
PS Properties 10	500	500	370	305	32.5%
PS Properties 12	500	505	428	290	28.9%
PS Properties 14	500	531	375	250	41.1%
RIC 15	100	119	92	80	27.7%
RIC 16	100	115	88	79	27.6%
RIC 17	100	109	93	80	20.6%
RIC 18	100	107	86	68	28.0%
RIC 19	100	104	75	71	30.0%
RIC 20	100	98	85	75	18.4%
RIC 21	100	95	85	70	18.4%
RIC 22	100	95	69	62	*31.1%

Partnership interests trade primarily on a yield basis. Therefore, price is determined significantly by cash distributions. So, unless the rolled-up entity reduces cash distributions compared to the constituent partnerships, the roll-up should trade on no less favorable terms than the constituent partnerships.

Let's use a hypothetical example to illustrate the math involved and to show the important differences between appraised value, exchange value and market value. Three constituent partnerships (A, B and C) have the following characteristics (dollars per partnership interest, or unit):

	A	B	C	Aggregate of A, B & C
Net operating income	\$ 100	\$ 150	\$ 200	\$ 450
Gross appraised value	1,111	1,667	2,222	5,000
Less: Debt balance	500	700	900	2,100
Net appraised value	611	967	1,322	2,900
Cash distribution	50	80	110	240
Trading price	417	667	917	2,000
Exchange value	10	10	10	10
Shares received	61	97	132	290
Share value on 12% yield basis	417	667	917	2,000

Notes: The net appraised value is determined by capitalizing net operating income at a rate of 9% and subtracting the debt balance. The trading price represents a 12% yield on cash distributions, approximately today's average yield. The number of shares received is determined by the appraised value divided by the exchange value of \$10 (not arbitrarily).

In the example, 290 units of aggregate in the new entity would be exchanged for the three partnerships and 290 units would receive

\$240 of cash distributions, or \$.82 per unit. At a 12% yield, the units would sell at \$6.90, and the aggregate price of all units would equal the aggregate trading value of the constituent partnerships prior to the roll-up. The roll-up, per se, has not caused a loss of value.

The trading price of \$6.90 per unit is a substantial discount from the appraised value of \$10 per unit. But, the purpose of the appraisal is to determine accurate ratios for the exchange of each constituent partnership into the surviving entity not to predict the trading price of the security. Further, the purpose of the exchange value is to apportion the securities among partnerships in a mathematically exact manner and not to predict the trading price of the security. The exchange value is typically set by the investment banker, not the appraiser.

Fees and Enrichment of the General Partner

Transaction costs have been high in some cases and are largely born by investors. In addition, in many, but not all, reorganizations investors are asked to vote for additional compensation for the general partner compared to the compensation called for at the time of the original offering.

Transaction costs for reorganizations have ranged from a high of about 7% of asset value to a low of 1%. When fairness opinions are involved and vote solicitation expenses are significant, typical transaction costs are 3% of asset value. This expense is a direct reduction in value for investors. We believe the irreducible costs of reorganization are 1% (proxy/prospectus preparation, proxy solicitation). So, the incremental cost of the average transaction of 2% of value has no material impact on investor values in absolute terms.

Also, most reorganizations result in lower annual general and administrative costs which tend to offset the impact of transaction costs. Even in a recent controversial roll-up (Equitec/Hallwood) there were net savings. The aggregate constituent partnership's general and administrative costs were \$6 million annually. The new manager (the general partner interest was sold in this case to a new manager) agreed to cap such costs at \$2.5 million annually. In this reorganization, transaction costs were \$10 million.

When most partnerships are formed the general partner receives fees (called "front-end" fees) for organizing the partnership and acquiring the assets. Such fees have represented the overwhelming majority of general partner compensation to date. In addition, the general partner is entitled to ongoing management fees (called "operational phase" fees) and fees for disposition of as-

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sets and a percentage of gain (so called "back-end" or "liquidation phase" fees). Typically the operational phase and liquidation phase fees are subordinated to the investor receiving a minimum return (often 6% to 8% of his investment per year). The minimum return is cumulative and if unpaid the arrears must be cleared before any general partner compensation is paid.

In addition, not all the general partner's general and administrative costs can be charged to the partnership. For instance, rent, utilities, insurance and salaries of supervisory personnel and executive officers are not charged to partnerships pursuant to NASD rules (Appendix F). Therefore, the task of administering partnerships is representing an out-of-pocket cost (net of any revenue) to most general partners today.

Obviously, the general partner entered into the transaction with the same expectation as the investor, namely that property cash flow would rise. In reality and in general, property cash flow has fallen below the investor minimum return requirements resulting in no current operational phase general partner compensation. No doubt general partners entered into these arrangements voluntarily and profited significantly from front-end fees. Nevertheless, currently, many general partners not only receive no current management compensation but incur unreimbursed cost.

Common sense would indicate that the current situation is not in the best interests of the investor, or the general partner, and is a significant reason why reorganizations are occurring today. Clearly, no replacement general partner or new asset manager would assume the role without compensation. So, however the situation is resolved, the investor will end up paying more fees than originally contemplated. If real estate values and cash flows had risen, the necessity of changing compensation arrangements would be obviated because the real estate would be paying the general partner.

We argue, therefore, that the roll-up is not at fault. Investment performance is the villain along with regulatory provisions limiting and conditioning compensation which, in hindsight, may not prove protective of investors.

One element of compensation involved in some reorganizations appears potentially abusive and bears careful scrutiny. In some cases, the "going concern" value of the general partner entity is calculated and a capital interest (stock of or other interests in the new entity) is awarded for merging in the general partner's business. Forgetting valuation questions, where the general partner has assets or income from businesses outside the constituent partnerships, the practice is not objectionable. Where the going concern value consists of the present value of fees from the constituent partnerships which are as yet unearned, inequity can easily result. Further, the likelihood and size of

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the eventual payment of such fees is often based on the appraisal which may or may not reflect economic reality. In any event, where such fees are based on conjectural (as opposed to contractual) rights to receive income, giving the general partner a current capital interest in exchange for these rights is a questionable practice.

Investors are Better Off Without the Roll-Up

The argument states that the existing secondary market provides adequate liquidity and the roll-up is not required. In fact, about 3,500 partnerships currently file financial reports with the SEC with about 2,000 accounting for about 75% of the paid-in capital. We estimate that about 25% of these larger publicly registered untraded partnerships, or 400 partnerships, trade in any given year. Probably no partnership trades daily and most do not trade as often as weekly. In many, months go by between trades. Turnover is probably less than 0.5% of total capitalization per year versus turnover of 33 1/3% of total capitalization for NYSE stocks. Statistically, one cannot argue liquidity is present for untraded partnerships today.

However, we do not believe that trading markets are necessary or desirable for partnership securities. Our research indicates assets held in corporate form (REIT, or "C" corporation for oil and gas assets) command higher market prices than partnership securities representing the same assets. Our research confirms the analysis of Realty Stock Review cited earlier.

The popular press and the critics of reorganizations intimate that appraised values are the "real" value, or the value at which assets could be liquidated currently (and liquidation proceeds distributed to investors). So, the investor is better off if the general partner liquidates instead of rolling-up. Appraised values take into account future income estimates (usually inflated) as well as current income. In today's real estate climate, the transaction price for property and the market price of real estate securities seem to focus more on current income and in some cases even discount current income. The resulting difference between appraised value and trading prices does not represent loss from reorganizing, or chicanery, just the reality of the market for real estate securities today.

Unfortunately, selling commercial and multi-family real estate today is all but impossible. The natural glut is enormous and is made worse by the disposition activities of the RTC and the FDIC. Tax incentives available in the mid-1970's for buyers to come forth -- the time of the last real estate "depression" -- have been removed from the Tax Code. A buyer has no incentive to absorb and fund an operating loss on a property because an in-

dividual cannot deduct real estate losses from other income. The combination of a property glut and no buyers makes real estate partnership liquidation by property sales impractical now and perhaps for a long time to come.

A Cram Down is Bad

A "cram down" is defined as a transaction in which the majority, say 50.1%, determines the fate of the minority whereby the minority must accept the securities selected by the majority. Forgetting the philosophy of majority rule, other ways of looking at the voting process may put some balance in this part of the discussion. For instance assume 50.1% voted "no" and 49.9% voted "yes" for the reorganization. The "no" majority prevented a very large minority from exchanging illiquid interests for trading securities.

We understand the total units voted in most roll-ups does not exceed 75% of the total units outstanding. To achieve a simple majority about 70% of those voting must favor the transaction. So, even majority rule provides a very substantial opportunity for a comparative small minority of investors to thwart the will of a much larger majority.

The no "cram down" argument includes the notion that roll-ups merge "good" partnerships and "bad" partnerships so their impact is not uniform. The appraisals and fairness opinions uniformly present in roll-up prospectuses are specifically designed to prevent this feared result. Further, one asset or asset pool may look sound today and develop problems tomorrow. Often such changes in value are simply not predictable because they rely on exogenous factors like the independent decisions of tenants. However, advantages of roll-ups include strength through diversification and a pooling of assets to facilitate financing both of which are generally considered investor benefits.

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The solution often voiced to avoid a cram down is leaving some investors in the original partnership. Those desiring to roll-up can take the new, traded security. I question practically whether this solution is feasible or serves well either the remaining or the departing investor.

The only method to accomplish this result is to give the new entity and the old entity undivided interests in the partnership's building or buildings. Hypothetically let's say the roll-up entity has a larger property base and cash flow. Further suppose a building requires cash to pay debt service, tenant improvements, leasing commissions, etc. which the roll-up entity can afford and which the old partnership can not afford. How is the conflict resolved? Say the old partnership wants to sell the building to raise cash to meet other financial obligations. How do you price and sell an undivided minority interest in a building?

An apparently workable solution was provided in the original CRI reorganization. Here two new entities, both roll-ups if you will, were formed. One was a liquidating entity and the other was a perpetual life entity. The property is held in the liquidating entity in which the perpetual entity is the largest shareholder. In the early stages, this arrangement works because undivided property interests are not created. Over time, this arrangement may prove a disadvantage to the perpetual entity investors. The buildings are sold and the cash is paid to liquidating entity investors and to the perpetual entity which will reinvest the cash in another building. Obviously, the perpetual entity would have been better off not incurring the costs of both the purchase and sale transactions (potentially a total of 6% to 12% of property value) but just holding the original building.

In Conclusion

Objectionable elements of roll-ups are present in many transactions. These include: extraordinary transaction costs, often in excess of 3% of asset value; giving the general partner an interest in the new entity equal to the present value of unearned fees; picking the wrong new entity (a "C" corporation to hold real estate or a master limited partnership to hold any asset); immediate listing or trading (unfortunately this result can be caused by the "Blue Sky" process); unfair proxy practices, like harassment of unitholders and setting an early date for the vote; proxy documents without clear summaries, and not providing dissidents with some cash out alternative at some point.

Determining whether to address these issues through legislation, regulation or the glare of public scrutiny and market forces is beyond our area of competence. I would simply note that the most recent large reorganization has been restructured three times because of initial, substantial negative reaction to the transaction by the broker/dealer community. In part, the Congress can take credit because by holding hearings you have focused the investor and brokerage community attention on the issues and are influencing the outcome in a manner favorable to investors even absent new legislation or regulation.

APPENDIX

Testimony of Robert A. Stanger
Chairman
Robert A. Stanger & Co.
Before Hearings of the Subcommittee on Securities
of the Senate Committee on Banking, Housing and Urban Affairs
Delivered, Wednesday, February 27, 1991

List of articles attached hereto related to Robert A. Stanger & Co.'s methods of analyzing and grading partnership roll-ups.

"Analyzing Real Estate Roll-ups" (The Stanger Report, Sept. 1987)

"Analyzing Roll-ups" (The Stanger Report, Sept. 1990)

"Grading Roll-ups" (The Stanger Report, Dec. 1990)

"Grading Roll-ups: How the Deals Score" (The Stanger Report,
Jan. 1991)

"Revised Roll-up Report Card" (The Stanger Report, Feb. 1991)

DUE DILIGENCE

Analyzing Roll-Ups

With more partnership roll-ups and conversions to REIT form sure to come down the pike, you need a system for evaluating these transactions and advising your clients. Here's a two-step master plan of how to proceed. First, you should determine the appeal and probable trading price of the new securities resulting from the roll-up. And second, evaluate the impact of the roll-up on your individual partnership.

JUDGING THE NEW ENTITY

Start with the prospectus/proxy statement to get a feel for the composition of the assets, overall leverage, cash flow and earnings of the new merged firm. The "Summary" pages provide most of the information you'll need. Often, the merged firm will have investment characteristics superior to the individual partnerships. For instance, diversification is often improved. The new entity may be leveraged less than your partnership, reducing risk. Sometimes borrowing capacity becomes available. Possibly, operating cash flow from healthy partnerships can be deployed to rescue or enhance assets in less healthy partnerships.

Here are other specifics you should check.

- **Review the business plan** -- Usually, the general partner will state the business plan he'll follow in managing the merged firm. The merged firm's value in trading markets will be affected by how well-defined the plan is. Also, if a new GP is coming on board, look at the "Management" section to get a feel for management's experience and ability to execute the plan successfully.

Check whether or not the new entity will be "liquidating" (as your original partnership) or "perpetual." With a liquidating roll-up, proceeds for property sales will go to you. Perpetual funds reinvest proceeds, so the only way you'll realize value

is to sell your interest on trading markets -- often at some discount to asset value.

- **Estimate the trading value of the merged firm's securities** -- You can get a rough idea fairly easily. Take a real estate roll-up. Ignore the appraised values or exchange values shown in the prospectus. Instead, look at the net operating cash flow (revenues less operating expenses and debt payments) shown on the pro forma financial statement. As a rule of thumb, a master limited partnership (MLP) will probably trade at a price where net operating cash flow yields around 12%. If the merged firm is a REIT, the securities will probably sell at a lower cash flow yield, 10% or less. Said another way, the trading value of the merged firm will be a multiple of 8 (MLP) to 10 (REIT) times operating cash flow.

Caution: Don't be misled by the cash distribution policy that's stated in the prospectus. The market tends to value the security based on actual cash earnings (cash flow from property in real estate roll-ups). And, the cash earnings of the real estate portfolio do not necessarily square with cash distribution rates in the short run.

- **Look at the new firm's "democracy rights"** -- Another factor strongly influencing the trading price of the securities is democracy rights. Normally in corporate America, 51% of the stockholders can kick out management or agree to sell the company. The same "simple majority" should be a characteristic of the roll-up entity. However, in roll-ups the limited partners often agree to what are so-called "super-majority" provisions. Here, two-thirds to 80% of LPs must vote to kick out the general partner (management) or approve a merger or sale transaction. Such super-majority provisions definitely reduce the value of the securities in trading markets.
- **Consider the tax implications** -- Some roll-ups are tax-free exchanges, and some are taxable.

Generally, a conversion from partnership form to REIT form will be taxable if several partnerships are involved. A merger of partnerships resulting in an MLP is a tax-free exchange. However, rolling your partnership into a publicly traded MLP will convert the partnership's future passive activity income (or loss) to portfolio income (or loss). This change can effect some investors. Also, MLPs generate UBTI (Unrelated Business Taxable Income) for pension investors.

- **Check out the fees relative to the "efficiencies"** -- Typically in a roll-up, future fees earned by, or due to, the general partner are accelerated by a present value factor and paid to the general partner by giving him an interest in the merged firm. Another dilution of the pre-roll-up economics of your partnership comes from the costs of the transaction. It's not unusual for 10%-15% of the equity value to be absorbed by fees of investment bankers, vote solicitations, appraisals and other incidental costs. On the positive side, roll-ups frequently result in general and administrative cost savings. The theory is simple. The merged firm buys one audit, maintains one set of records and files one financial report.

IMPACT ON YOUR PARTNERSHIP

Once you have concluded about the profile and value of the roll-up entity, you need to gauge the im-

pact of the transaction on your particular partnership. Don't concentrate on book value or exchange value. The more practical approach is to look at your investment "before" and "after" the roll-up. Here are the points to check out.

- **Compare "before & after" cash distributions** -- You'll know what your latest cash distribution was per \$1,000 of original investment. Compare your partnership's distribution with the distributions you'll get pro forma from the roll-up. (A table in the prospectus presents this data.) In general, you benefit if the amount goes up from the consolidation; you suffer if your distribution goes down. The decline is the price you are paying for instant liquidity.

Generally in a roll-up, all partnerships are not treated the same in terms of before and after cash distributions. The reason: The basis of the exchange is usually appraised value not cash flow. Unfortunately, the securities of the roll-up will trade on a yield basis, not asset value.

- **Compare "before & after" distribution coverage** -- On a more sophisticated but more telling level, look in the latest partnership quarterly report to see the cash flow from operations versus the aggregate cash distributions from the partnership. Comparing the two tells you how much of the partnership's distribution was "earned".

Now, make the same comparison for the new roll-up entity from the pro forma financial statement

IN UPCOMING ISSUES

- | | |
|--|--|
| • Low Income Housing:
The Real Economic Story | • Looking For Healthy
Office Markets |
| • Getting The Best Price
In The LP Secondary Market | • How To Advise Clients With
Troubled Investments |
| • New Shelter Technique
For High Income Clients | • Top Oil & Gas And
Cable TV Sponsors |

Improving The Fairness Of Roll-Ups

Two techniques benefiting limited partners -- employed in the conversion of Union Exploration Partners, a publicly traded MLP, to corporate form -- probably can be adopted in partnership roll-ups or mergers if the general partner is trying to be more "fair" to investors. First, you were given "appraisal rights." And second, in the event of a drop in the price of the stock after the conversion, you were eligible for a substantial cash distribution.

Union Exploration gave limited partners an "appraisal right" identical to the provisions of Texas law for dissenters in corporate mergers, even though appraisal rights do not apply to Texas partnerships. A partner desiring not to convert to corporate form could receive all cash for his partnership unit. The process: You notify the general partner 20 days after the merger if you do not wish to convert. You state the "fair value" you want for your interest. Within 60 days the general partner accepts your value or offers a different value to you. If you cannot agree, an independent appraiser sets the price. Probably few investors would bother with the process, but making the option available has cosmetic appeal and provides an element of fairness.

Union Oil also offered to pay you up to \$3.00 per partnership unit if, following conversion, the share price 60 days after the conversion dropped to below the MLP's average trading price of \$18.00 before the conversion was announced. In other words, you are reimbursed in cash for up to the first three dollars of any drop in the stock price.

Besides these two "fairness" techniques for roll-ups, look at the acceptance of corporate securities versus partnership securities in public trading markets. Pro forma in Union Exploration, the earnings dropped from a \$1.03 pretax per unit to \$.52 per share after tax. The dividend was cut from \$1.78 to \$.40 -- down 78%. But, the stock only dropped \$3 to \$15, or 17%!

in the prospectus. Look to see if you are going from a situation where most or all of your distribution is earned to one where the distribution is not earned. That's bad -- a deterioration of the quality, or earnings coverage, of the distribution. The reverse could be true, which is good.

- Compare the likely trading price with LP "secondary" market prices -- You can assume the securities you will receive will sell on the market at a 10% current yield or higher. Calculate the trading value of your holdings, and then compare with the value you could have obtained (prior to the announcement of the roll-up) by selling in the informal secondary, or matching service market (if there is one for your partnership). Since informal secondary markets discount so heavily, you'd expect the exchange to price out more attractively.
- Check your partnership's cash position before and after the roll-up -- High cash positions suggest a healthier partnership -- one probably more able to stand alone without the merger. Compare cash per unit on your partnership's most recent quarterly balance sheet with cash per your exchange unit(s) on the merged firm's pro forma balance sheet to get a rough feel for the "dilution"

of your cash position. Also, to the extent the market values the roll-up entity at some discount to asset value, partnerships with higher cash positions are penalized in the roll-up.

I DON'T LIKE IT

If you object to a roll-up, you have no easy redress. One approach is to sue to enjoin the transaction -- expensive and time consuming. Another is to circle the wagons: Form a committee of other similar-minded limited partners and try to influence the vote.

Certainly if you bought the investment from a broker/dealer, your most practical approach is to appeal for help. At least you start with a group voice instead of that of an individual. Also, the broker/dealer has a stake in helping you -- avoiding legal action against the broker/dealer. One approach for the broker/dealer to take is the white knight -- try to find a bidder to pay cash for the partnership or locate a replacement general partner to keep the old partnership alive. ■

FORECAST OF CABLE SUBSCRIPTION FEES

Year	Growth in	
	Average Monthly Basic Cable Fees	Average Monthly Subscription Fee
1989	\$ 13.00	—
1990	13.70	5.4%
1991	14.30	4.4%
1992	14.90	4.2%
1993	15.40	3.4%
1994	15.90	3.2%

Compound Annual Growth 4.1%

Source: Veronis, Suhler & Associates, Wilkofsky Gruen Associates

Over the next five years, basic cable subscription fees will rise at a 4.1% compound annual rate, more in line with the projected overall rate of inflation than with the fee increases of the last three years. (See table above.)

ADVERTISING

By 1994, basic cable's share of total TV viewing is expected to rise to 17.5%, from 14.1% in 1989. Although growth rates are moderating, the larger audience of basic cable network viewers will successfully attract more national advertising. Over the next five years, spending on national cable advertising is expected to

FORECAST OF CABLE ADVERTISING SPENDING (\$ in millions)

Year				% Change From Prior Year
	National	Local	Total	
1989	\$ 1,225	\$ 340	\$ 1,565	—
1990	1,470	405	1,875	19.8%
1991	1,685	465	2,150	14.7%
1992	1,895	530	2,425	12.8%
1993	2,100	600	2,700	11.3%
1994	2,310	665	2,975	10.2%

Compound Annual Growth 13.5% 14.4% 13.7%

Source: Veronis, Suhler & Associates, Wilkofsky Gruen Associates

rise at a 13.5% compound annual rate — lower than the 21.7% annual growth of 1984-1989, but well above the anticipated 6.6% growth of network television advertising. By 1994, national cable advertising is expected to exceed \$2.3 billion, almost double the current level of spending.

Local cable advertising is expected to rise from \$340 million in 1989 to \$665 million, growing at a compound annual rate of 14.4% — also well below the 33.6% increase of the 1984-1989 period. Total cable advertising will grow to nearly \$3.0 billion by 1994, a 13.7% compound annual gain, compared to the 23.8% rise of the previous five years. ■

DUE DILIGENCE

Grading Roll-Ups

In the realm of roll-ups, views seem to come only in black or white. Sponsors and service providers, like investment bankers and fairness opinion givers, love roll-ups. Brokers, planners, the press, and secondary market makers hate them. But, even the vocal opposition to roll-ups acknowledges the possibility of "doing one right."

Robert A. Stanger & Co. has developed a "Report Card" to help you grade the next deal you see. We've identified eighteen key elements representing the best and fairest provisions in roll-ups. The elements are divided in two groups. The first relates to the merger/

THE STANGER REPORT

conversion and establishes whether or not you are treated fairly. The second relates to the market acceptance of the securities you receive in the exchange, mapping out criteria to help you judge if the roll-up has a shot at a reasonable trading price in the market. A passing grade on the test means you can recommend a "yes" vote to your clients. (In upcoming issues, we'll apply the test to some major transactions and show you how they score.)

If all investors are given an option to take cash (or good notes) at or near net asset value, your roll-up receives an A+, and you need read no further. But so

far, the "all cash" option has not been a part of any roll-up, so read on.

MERGER/CONVERSION FAIRNESS

- **Test #1: Choice of Entity** — Usually you are asked either to approve merging your partnership into a new entity or to turn the proposition down. This type of transaction is called a "cram down" or a "freeze out." If 51% of partnership units vote "yes," the opposing minority is included in the merger and you are taken out of the original investment. Paradoxically, you could call this arrangement a "freeze in" as well. If 51% vote "no," the minority are denied exchanging into the new entity and are frozen in the original investment.

Roll-ups not offering you the choice of remaining with your original investment (or, at the least, providing you with the option to select an entity with policies and objectives similar to the original investment — e.g., a liquidating entity) fail Test #1. If the roll-up allows you a choice of investments, one of which is like the investment you originally bought, award ten points.

- **Test #2 & #3: Significant Changes in Investment Objectives and Policies** — Most partnerships are formed with the intention to liquidate within ten years. If the new entity has infinite life (perpetual), the investment objective has significantly changed. You are now at the mercy of the securities trading markets. If your partnership was unleveraged and bought commercial property and the new entity will leverage and concentrate in residential property, investment policies have changed significantly.
- **Test #4: Compensation Change** — Take a "before and after" look at annual fees, disposition fees and capital percentages to see if management, the general partner, is enriched by the transaction. If management is considerably better off after the merger, the deal flunks. Another move that gets an automatic flunking grade is giving management a capital interest in the new entity equal to the *theoretical* present value of fees in the old deal which are subordinated or as yet unearned.
- **Test #5: Expense Reductions** — One oft-cited reason for roll-ups is "economies of scale" — savings resulting from spreading partnership overhead over a broader base. If general and administrative costs shown in the pro forma are 5% lower after the roll-up, the deal passes.
- **Test #6: Exchange Value Realism** — How close the

likely trading price of the new security will be to the "exchange value" is a judgment call. The exchange value is developed by a generally accepted method applied uniformly to each partnership. But, the resulting exchange value is not necessarily the expected market value of the new security. Artificially high exchange values make management's track record look better and may establish higher than realistic fees for the general partner.

Your best tool to judge quickly the realism of the exchange value is to calculate a "yield" — net operating cash flow divided by the exchange value. In real estate roll-ups, for example, the "yield" is sometimes way below the yield real estate securities require in trading markets. So, the probable trading price is below the exchange value. If the roll-up's yield is one-third or more below the yield from similar securities, the exchange value is unrealistically high, and the roll-up flunks Test #6.

- **Test #7: Relative Fairness To Your Partnership** — A roll-up may make sense for one partnership in the transaction and not another. For instance, in Hollywood's roll-up, some Equitee partnerships had lots of cash which was discounted just like the real estate in determining exchange value, penalizing the cash-rich partnerships. Often, high cash flow partnerships are valued similarly to weak cash flow partnerships.
- **Test #8: Voting Procedures** — The principal negative occurs if you are allowed less than 45 days from notification of the roll-up to the date of the vote. Short notice does not allow adequate time for complete analysis, press coverage, counter offers or broker/dealer reaction. Give five points to a transaction announced more than 45 days before voting. Other voting elements to look for: whether differential compensation is paid for votes, how management interests are voted, how signed but unmarked ballots are counted and how "majority" is defined — absolute or just those voting (you prefer absolute). Fine tune the score by subtracting one point for each unfavorable element.
- **Test #9: Transaction Fees** — Roll-ups generate fees to lawyers, soliciting brokers, investment bankers, etc. In expensive deals, fees are over 3% of assets to be rolled up. That's too high, and the deal flunks Test #9. A fine point: See who pays so-called broken deal fees. If the partnerships do (which is common), that's bad news — especially when management stands to benefit significantly from higher fees. Subtract one point from the score.
- **Test #10: Role of Original Broker/Dealer** — If the original placing broker/dealer is involved in planning and structuring the roll-up, you pass Test #10. Partnership offering series often have many broker/

dealers, and not all of them can be involved in planning a roll-up. So, you need to make a judgment call. But, what may be particularly objectionable is for a broker/dealer which was not involved in the original offering to be dealer-manager of a roll-up. Why? Blackmail. The general partner threatens to give investor names to the new dealer-manager, thereby raiding the book of brokers who originally placed the partnership interests. If the original broker/dealers would not play, you're probably looking at a seriously flawed transaction.

- **Test #11: Tax Impact** — Judge if you will receive tax or tax reporting benefits in the transaction. If

you will get a 1099 versus a K-1, that's a good reason to favor the merger/consolidation. Often, you may benefit from realizing a tax loss on the exchange — occasionally, a tax cost may be involved.

VALUE OF RESULTING SECURITIES

This part of the roll-up analysis contains some black and white issues and a number which are subjective. Let's take a major black and white issue first.

ROLL-UP REPORT CARD

Name Of New Entity: _____

Check the answer to each question and circle the points for each "Yes" vote. Then, total up the circled points.

Test Number	Merger/Conversion Factors	No	Yes	Points
1.	Do you have an affirmative choice of entity?	_____	_____	10
2.	Does roll-up have the same investment objectives as original LP?	_____	_____	6
3.	Does roll-up have same investment policies as original LP?	_____	_____	6
4.	Does management compensation stay the same or decrease?	_____	_____	5
5.	Are partnership expenses reduced?	_____	_____	5
6.	Is exchange value realistic?	_____	_____	5
7.	Is exchange fair to your partnership?	_____	_____	5
8.	Are roll-up voting procedures fair?	_____	_____	5
9.	Are transaction fees reasonable?	_____	_____	5
10.	Is original placing broker/dealer involved?	_____	_____	5
11.	Do you receive tax or tax reporting benefits?	_____	_____	5
Value of Resulting Securities				
12.	Are cash distributions earned?	_____	_____	6
13.	Can current management accomplish the business plan?	_____	_____	6
14.	Does the new entity provide for simple majority votes?	_____	_____	6
15.	Are the new entity's overhead expenses and management fees fair?	_____	_____	5
16.	Does the entity have significant management ownership?	_____	_____	5
17.	Does the entity avoid significant conflicts of interest?	_____	_____	5
18.	Has your tax status improved or, at least, not changed?	_____	_____	5
Total Score				_____

- **Test #12: Distribution Coverage** — If cash distributions significantly exceed operating income, down comes the hammer on Test #12. "The market" cares most about actual earnings (operating income) and not about cash distributions. Further, paying out capital in a perpetual life entity reduces the earning asset base, another "market" negative.
- **Test #13: Business Plan** — Now, look at the economics of the new entity. Management should articulate a business plan and have the ability to deliver the hoped-for result. Subjectively, you have to decide if you believe the business plan makes sense. Then, take a look at management's ability to deliver based in part on the results of the last several years. Make your call.
- **Test #14: Shareholder Voting** — If the new entity has so-called "super-majority" rules, it flunks Test #14. Super-majority rules require two-thirds, or up to 80%, of holders to approve such things as mergers and management fee changes or removal. The result: Management tends to have more autonomy.
- **Test #15: Fairness of New Entity's Expenses** — The pro forma financial statement for the new entity will show estimated overhead expenses (including management fees). Compare these costs to asset value or to operating income and compare the result to other similar entities which are currently trading. In the case of REITs, for instance, high overhead expenses typically lead to a lower market valuation of the shares. (For a sample of 21 REITs tracked by Green Street Advisors, Inc., annual overhead expenses average roughly 15% of cash flow from operations, or about .75% of assets.) If overhead is high, the deal fails Test #15.
- **Test #16: Management Ownership** — For traded securities like REITs, analysts like to see significant management ownership of shares (say, over 5%). The idea is simple: Management should be motivated by more than current fees, and the motivation should parallel the interests of the shareholders. (Average insider ownership for the 21 REIT sample is 8.7%.) If management ownership is less than 2%, ring the gong on the deal.
- **Test #17: Conflicts of Interest** — Look for conflicts and understand the permissible transactions between management and affiliates. One conflict could be management fees based entirely on "net asset value" — a number which can be influenced by management. You prefer to see fees based on operating income, which depends solely on results. Transactions with affiliates, while normal among partnership sponsors, are unusual for other publicly traded companies. So, your grade here is a judgment call.
- **Test #18: Taxation of New Entity** — Finally, see if your tax status changes in the new entity. Publicly traded partnerships produce unrelated business taxable income ("UBTI") for otherwise tax-free accounts, and portfolio income versus passive income for the taxable investors — negative factors in the trading market. On the other hand, REITs and regular corporations do not produce UBTI or passive income, but rather generate portfolio income. If your tax status is improved or left neutral, the deal passes.

IN UPCOMING ISSUES

- Getting The Best Price
In The LP Secondary Market
- Developments In State
Taxation Of Partnerships
- How To Use Oil & Gas To Hedge
Inflation And Bear Stock Markets
- How To Advise Clients With
Troubled Investments
- Real Estate Sponsor
Performance Comparisons
- Low Income Housing:
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THE STANGER REPORT™

A GUIDE TO PARTNERSHIP INVESTING

VOLUME XIII, No. 1

JANUARY 1991

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DUE DILIGENCE

Grading Roll-Ups: How The Deals Score

Last month, we introduced a system you can use to grade roll-ups and determine when to recommend a yes vote in favor of the transaction. This month, we apply the test to six real estate transactions with an aggregate exchange value of \$1.9 billion. Four deals are currently in play (CRI's AIM roll-up, Krupp's Berkshire Realty deal, Concord's Milestone Properties, and United Realty Group's roll-up of 66

private deals), and two have been consummated (Hallwood Realty and CRIIMI MAE/CRI Liquidating). If you're sitting on the fence in deciding how to vote, these comparisons may help you make up your mind. The comparisons also help you pinpoint the strong and weak aspects of each roll-up and, therefore, provide a rational basis for seeking improvements in the terms of any deal.

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Only two of six roll-ups we tested pass our Roll-up Grading Test. (See Table 1.) Both were structured by CRI and feature liquidating options which preserve the objectives and policies of the original funds. CRI scored an impressive 88 points out of 100 for the 1989 merger of three insured mortgage programs into CRI Insured Mortgage Association (NYSE: CMM) and the companion liquidating entity CRI Liquidating REIT (NYSE: CFR). Today, CRI is using essentially the same roll-up structure in a hostile tender for four Integrated Resources mortgage programs ("AIM" funds). With 84 points, the CRIIMI MAE/AIM roll-up is the second best scoring transaction of the six tested. Four deals fail the test: Berkshire (Krupp); Milestone (Concord); Hallwood (Equitec); and United Realty.

The grading encompasses several distinct types of transactions: consolidations into REITs, MLPs and corporations; hostile versus friendly transactions; roll-

ups into perpetual life or liquidating entities; mortgage versus equity deals; and third-party versus sponsor-initiated transactions.

You can use Table 2 (on page 4) to pinpoint the strengths and weaknesses of each deal. The table shows each roll-up's score on each of eighteen criteria. The test evaluates two aspects of each deal: the fairness of the merger and the factors influencing the likely market value of the resulting securities.

You can also use the test results as a predictor of how the new entity might fare in trading markets. For example, CRI Liquidating scored highest on market value factors and trades close to appraised asset value. Hallwood scored lowest on market value factors and trades at 17% of appraised asset value. Table 3 (on page 6) summarizes how each roll-up scores on merger versus market factors.

Table 1
RANKING THE DEALS BY STANGER'S ROLL-UP TEST

Roll-Up	Stanger Roll-Up Test Score	Exchange Value (\$ Millions)	Proposed Number of Entities to be Merged	Primary Assets	Type
CRIIMI MAE/ CRI Liquidating	88.0	\$456	3	Federally Insured Mortgages	Sponsor, CRI, initiated roll-up into REIT with liquidating option
CRIIMI MAE/ AIM Liquidating ⁽¹⁾	84.0	\$532	4	Federally Insured Mortgages	Third-party hostile roll-up by CRI of Integrated AIM funds into REIT with liquidating option
Berkshire Realty Co. ⁽²⁾	36.0	\$548	4	Apartments & Shopping Centers	Sponsor, Krupp, initiated roll-up into REIT
Milestone Prop., Inc.	30.0	\$ 71	2	Free-Standing Retail/Shopping Centers	Sponsor, Concord, initiated roll-up into C corporation
Hallwood Realty Partners	22.5	\$283	11 ⁽⁴⁾	Offices	Third party, friendly roll-up by Hallwood of Equitec partnerships into MLP
United Realty Group ⁽³⁾	21.5	\$ 40	66	Shopping Centers	Sponsor initiated roll-up into MLP

(1) Based on S-4 registration statement dated 11/14/90

(2) Based on original filings and changes described in Supplement No. 2 to the Prospectus.

(3) Based on S-4 registration statement dated 10/5/90

(4) Eight partnerships accepted the roll-up

Here's a profile of how each transaction fares on Stanger's Roll-Up Test, from best to worst-scoring deals.

CRIIMI MAE/CRI LIQUIDATING

CRIIMI MAE/CRI Liquidating ("CRI/CRI"), one of the two completed transactions analyzed, passes the test with flying colors. On merger/conversion factors, the deal scores a near perfect 61 (of 62). The key: Preserving the investment objectives and policies of the original funds by giving investors an affirmative choice of entity between the original investment format (but with diversification) or a new growth vehicle. The liquidating entity holds the existing mortgages of the "rolled-up" funds and distributes all cash flow (from earnings and mortgage dispositions). The sister growth entity, which may leverage and reinvest in new mortgage investments, wouldn't necessarily pass the roll-up test. But you get a choice, so the deal passes. The deal also scores points because CRI's liquidating entity does not change management compensation relative to the original three mortgage funds.

Looking at other merger factors, CRI Liquidating's general and administrative expenses decrease 28% pro forma (based on 75% of investors opting for growth shares -- the actual exchange was 67%). Exchange values -- priced implicitly at a 7.5% equity yield (cash flow divided by exchange value) -- were reasonably realistic when the exchange was done back in 1989 because prior to the merger the three entities traded at 10.5% average dividend yields. Because all three funds were homogenous, each was treated fairly in the exchange.

As for voting procedures, the only negative was that investors electing growth shares, not Liquidating shares, received a special \$2.31 per share dividend -- an enticement into the more remunerative entity for CRI. Transaction fees -- estimated at around 2.2% of exchange value -- were passable. Except for fund-oriented transaction expenses like appraisals and accounting, broken deal expenses would have been borne by CRI. The roll-up was structured by the original placing broker/dealer, Merrill Lynch. Investors in two of the three merging funds (one was already a REIT) benefit from simplified tax reporting since 1099s will replace K-1s. CRI's merger into a REIT was taxable, but no adverse consequence resulted because trading values after the merger were close to the investors' tax bases.

CRI/CRI scored relatively worse on factors influencing the value of the resulting securities. Ten

points were deducted because management ownership is less than 2% and because "anti-takeover" provisions are present (e.g., staggered board, two-thirds vote requirement to approve an adverse tender). CRI Liquidating automatically passes the cash distribution coverage test since, by definition, a liquidating entity distributes all cash flow.

As for management, CRI can competently manage a portfolio of federally insured mortgages. (Past performance in the CRIIMI funds indicates CRI's ability to execute the business plan: the average annual return at the time of the roll-up was 13.3% in CRIIMI I, 8.8% in CRIIMI II and 5.1% in CRIIMI III.)

To judge CRI's compensation, we used a National Association of Real Estate Investment Trusts ("NAREIT") study of compensation relative to balance sheet assets. (The ratio is meaningful analytically because mortgage investments bear a closer resemblance to balance sheet values than do equity investments.) CRI's compensation and overhead expenses equal 0.6% of assets for CRI Liquidating, lower than the average mortgage REIT (1.4%). CRI's compensation on mortgage sales is subordinated to "target yields" for the original funds, mitigating conflicts of interest. CRI/CRI also earns five points for avoiding conflicts of interest, since the value (and size) of the growth entity (a 67% shareholder of CRI Liquidating) depends on maximizing the liquidation value of CRI Liquidating. Tax status was improved in two funds (MLPs) and unchanged in the third (REIT).

CRIIMI MAE/AIM LIQUIDATING

CRI employs essentially the same roll-up structure in its ongoing hostile bid for the AIM series as in the roll-up of its own insured mortgage programs. CRI/AIM (84 total points) scored below CRI/CRI because the original broker/dealer system of AIM (now owned by Broad, Inc.) is not yet (as of this writing) supporting the deal. But, the new positive is that all AIM unitholders receive a cash payout regardless of the choice between CRIIMI MAE and AIM Liquidating.

On all other points, CRI/AIM scores the same as CRI/CRI. Here's the summary: (1) Pro forma G&A expenses decrease 39% if 15% select AIM Liquidating (24% if 90% opt for AIM Liquidating); (2) the valuation of AIM's assets implies an equity yield of 12.1% -- within a reasonable range because all-mortgage REITs currently yield 15.9%. (Note: This

Table 2
ROLL-UP REPORT CARDS

Test No.	Merger/Conversion Factors	REITs			MLPs		CORP.	Points Possible
		CRI/CRI	CRI/AIM	Berkshire	Haltwood	United Realty	Milestones	
1.	Do you have an affirmative choice of entity?	10	10	0	0	0	0	10
2.	Does roll-up have the same investment objectives as original LP?	6	6	3	0	0	0	6
3.	Does roll-up have same investment policies as original LP?	6	6	2	2	5	0	6
4.	Does management compensation stay the same or decrease?	5	5	2.5	4	3	0	5
5.	Are partnership expenses reduced?	5	5	0	5	0	0	5
6.	Is exchange value realistic?	5	5	0	0	0	0	5
7.	Is exchange fair to your partnership?	5	5	4	0	0	4	5
8.	Are roll-up voting procedures fair?	4	5	1	4	N/A*	5	5
9.	Are transaction fees reasonable?	5	5	5	1	0	4	5
10.	Is original placing broker/dealer involved?	5	0	0	2	0	0*	5
11.	Do existing investors receive tax or tax reporting benefits?	5	5	5	0	0	2	5
Value of Resulting Securities								
12.	Are cash distributions earned?	6	6	0	0	0	6	6
13.	Can current management accomplish the business plan?	6	6	2	2	0	2	6
14.	Does the new entity provide for simple majority votes?	0	0	0	0	6	0	6
15.	Are the new entity's overhead expenses and management fees fair?	5	5	4	2.5	2.5	0	5
16.	Does the entity have significant management ownership?	0	0	2.5	0	4	5	5
17.	Does entity avoid significant conflicts of interest?	5	5	0	0	0	0	5
18.	Has entity's tax status improved or, at least, not changed?	5	5	5	0	0	2	5
Total Score		68.0	84.0	36.0	22.5	21.5*	30.0	100

*Notes: Milestones -- transaction involves no soliciting broker/dealer. United Realty -- not yet effective, so time allowed for investors to review offer is not yet known. Overall score weighted to reflect exclusion of this factor.

test doesn't have the same meaning for investors choosing CRIIMI MAE because CRIIMI MAE shareholders benefit to the extent AIM assets are undervalued for exchange purposes. In other words, CRI is motivated to conservatively value AIM and shouldn't be rewarded with a better test score.) (3) Transaction fees equal 3% of exchange value, on the margin for a "passing" grade. And, (4) management fees and overhead are 0.6% of total assets -- below the industry norm.

BERKSHIRE REALTY COMPANY

Berkshire ("BRI"), Krupp's roll-up of four partnerships into a REIT, scores 36.0 points -- 22.5 for merger factors and 13.5 for the value of resulting securities. Favorable merger factors include an option to vote for liquidation in 1998 (not as good as preserving a liquidating entity option, so score only three out of six points), tax reporting benefits (1099s versus K-1s), passing transaction fees (2.9% of exchange value), and fairness of the exchange to each partnership (one point was deducted for a three-property partnership which would probably benefit more from liquidating). Investors still face the "cram down", however.

Among the major negatives: investment policies change because proceeds from mortgage-backed securities can be rolled over into new property investments, leverage may be incurred, and property sale proceeds can be reinvested. (Two points were awarded for a likely focus on property types similar to the current partnerships' holdings of apartments and shopping centers.) Total management compensation doesn't increase on the pro forma, but asset management fees are earned on new properties. Plus, Krupp can earn acquisition fees and property management fees on new acquisitions, mortgage origination fees, and disposition fees equal to 10% of the "value created" (deduct 2.5 points). Partnership expenses don't budge -- a five point penalty.

Other negatives include an unrealistic exchange value -- 6.6% implied cap rate versus 10.9% for similar entities -- and restrictive voting practices because not enough time (40 days) was originally allowed for prospectus review. (Krupp sought to convert in 1990 and avoid saddling investors with K-1s in 1991.) Interestingly, many original selling broker/dealers haven't signed solicitation agreements -- possible confirmation of the negative factors.

Berkshire's securities probably will have a tough time trading close to net asset value. In BRI's favor:

size and a strong balance sheet (i.e., no debt initially). But the fact that distributions exceed operating cash flow by 38% is troubling. BRI must pay out capital or borrow to bridge the "earnings gap." Either solution squeezes future cash flow per share. Said another way, BRI is a candidate for a dividend cut -- a sure-fire way for an income-generating security to lose the interest of money managers and analysts.

Looking at the prior performance of Krupp's Cash Plus series (average annual total return equal to around 1%) and its leveraged public funds (all cash dry on distributions) gives little comfort that BRI can execute the business plan. Plus, trying to grow cash flow while running the REIT at a cash flow deficit is like trying to run a footrace in shackles. Nevertheless, BRI's operating strategy (versus cash management strategy) is sensible, so two points are scored for the business plan. Other negatives for the likely value of BRI's securities include hurdles to outsiders gaining control (two-thirds vote required in an adverse tender) and conflicts of interest (management fees are not based on performance, competition exists for management attention among other managed funds, and advisory and property management contracts are "locked-in").

Krupp's 2% ownership of BRI -- slim by comparison to the 8.7% management ownership of the average REIT -- earns only 2.5 test points. Management compensation as a percentage of asset value (0.6%) is fair relative to other equity REITs (0.75%), and is fair as a percentage of cash flow (7% vs. 15% for the average REIT). We award four out of five points because Krupp can earn more fees by acquiring properties. Avoiding UBTI in the REIT structure is a positive.

MILESTONE PROPERTIES

Milestone is the roll-up into a corporation of two unleveraged income funds sponsored by Concord Assets. The plan is to use the corporate vehicle to manage Milestone's current properties and to engage in new ventures, including property management, development and redevelopment/expansion of un-owned shopping centers. Milestone would give investors roughly 75% of exchange value in dividend-paying preferred shares and 25% in common shares (no dividend).

Milestone flunks the roll-up test on the following merger points: (1) you are given no affirmative choice of entity; (2) investment objectives change (perpetual

Table 3
OVERALL SCORING ON
MERGER/CONVERSION FAIRNESS AND SECURITIES VALUE FACTORS

	Points Possible	CRI/CRI	CRI/AIM	Berkshire	Milestone	Hallwood	Unked Realty
Merger/Conversion Factors	62.0	61.0	57.0	22.5	15.0	18.0	9.0
Value of Resulting Securities	38.0	37.0	27.0	13.5	15.0	4.5	12.5
TOTAL SCORE	100.0	88.0	84.0	36.0	30.0	22.5	21.5

versus liquidating entity); (3) investment policies are altered by permitting leverage and real estate development; (4) the deal allocates 29% of common shares (9% of total shares including preferred stock) to the GP based on the theoretical present value of future compensation; and (5) expenses increase markedly because overhead becomes allocable to the corporation. (Prior to the roll-up, the partnerships were restricted in reimbursing the GP for overhead and executive compensation.)

Finally, although the properties are reasonably valued relative to the securities markets (8.9% implied cap rate vs. 10.9% for traded entities), the increase in overhead expenses and corporate taxes resulting from the roll-up reduces the implied equity yield to 5.5%. That's not competitive with other securities and will likely cause Milestone to trade substantially below net asset value.

Milestone earns some points for merger factors. The exchange seems fair to both partnerships -- although you could argue that the partnership with only two properties should be liquidated (deduct one point). Other positives: investors receive tax reporting benefits (1099s versus K-1s) and the exchange is tax free for most unitholders (subtract three points for conversion to the double-taxed corporate form); transaction voting procedures are fair; and transaction fees and expenses, are the lowest of any deal we've seen (1.1% of exchange value), although investors pay most broken deal fees (subtract one point).

As for the probable market value, Milestone's securities will probably be hurt by high management fees and overhead, anti-takeover provisions, significant conflicts of interest (the business plan includes ventures with affiliated partnerships), and despite avoiding UBTI (score two points), double taxation on dividends paid. You can not conclude

management can achieve the business plan since a specific strategy is not articulated. Finally, Milestone's small market capitalization will discourage analyst coverage.

The negatives may be mitigated to some extent by 130% preferred dividend coverage and meaningful management stock ownership (9% of all shares including the preferred stock).

HALLWOOD REALTY

Hallwood's roll-up of eleven Equitec partnerships into an MLP ("HRY") scores only 22.5 total points -- 18 from merger/conversion factors. HRY's recent stock price performance confirms the dismal score posted by the deal in market valuation factors.

On the merger factors, HRY scores points for decreasing management compensation by 45% (pro forma) and for reducing G&A 55% (reduced G&A may only last for two years until the guarantee by Hallwood expires). Other positive merger points generally include fair voting procedures (score four points of a possible five) and continuity of investment objectives for some funds (2 points).

The big negatives include: the "cram down" (no choice of entity), an unrealistic exchange value (3.6% implied yield on equity versus 11.9% for all-equity REITs), high transaction fees (6.7% of exchange value including the payment to Equitec), a flawed methodology for determining exchange values (particularly for unleveraged funds and funds with high cash reserves), and a worsened tax situation (K-1s, UBTI, "suspended" losses, and portfolio versus passive income).

As for market valuation factors, the positive is that financially strong Hallwood replaces Equitec (bankrupt) as general partner, and Hallwood has workout experience. Only two points out of five were awarded for ability to execute the business plan (recover value in existing properties and reinvest in commercial properties), because office markets are probably the most depressed of any property type and the entity's debt is high enough for liquidity to become a problem. Management compensation and overhead expenses are a mixed bag (2-1/2 points were awarded) -- HRY's overhead equals 32% of cash flow versus 15% for major equity REITs, but only 0.84% of estimated asset value versus 0.75% for typical REITs.

HRY's securities have had (and probably will continue to have) rough sledding in the after-market. The reasons: First, distributions are set at 140% of cash flow, without any allowance for leasing costs, tenant improvements and other capital expenditures. Next, HRY's general partner is entrenched with a two-thirds limited partner vote necessary to unseat. Management ownership (1%) is slim. HRY faces conflicts of interest in a "non-incentivized" fee structure (i.e., compensation isn't linked to operating fundamentals or stock price). Other conflicts include a lack of motivation in the compensation formula to add value to existing properties, HRY's right to issue securities senior to current unitholders, competition for senior management's time by other entities, and the ability of HRY's general partner to earn fees on new acquisitions.

UNITED REALTY

United Realty, the current roll-up of 66 private programs, earns a meager 21.5 test points -- the lowest score posted. United fails on virtually all merger factors, except for the fact that the resultant entity will still hold leveraged shopping centers. By converting to a non-liquidating entity, each

partnership's original investment objective is lost. As for management compensation, United awards the economic benefits of a 5% interest to the GP in exchange for a nominal capital contribution. Despite the step-up in GP interest, current overall compensation does decline (score 3 points of a possible 5). Partnership expenses are expected to increase 28%. Exchange values, at an implied 1.3% equity yield (extremely low due to high debt), are unrealistic versus the 11.9% equity yield commanded by all-equity REITs.

Exchange values do not appear fair to all the 66 merging partnerships. Nearly all partnerships own one property, and the quality of properties (and valuations relative to original LP investment) varies dramatically. In fact, some partnerships with negative equity are being merged. Some properties and partnerships should probably be liquidated instead of merged. At 4.7% of exchange value, transaction fees are high. United's tax situation is worsened by becoming a publicly traded partnership.

United's securities will probably receive the coldest market reception of all the roll-ups reviewed here. The reasons: high leverage, small expected market capitalization, poor cash flow, troubled properties, and the MLP structure. Excluding capital expenditures, United will initially distribute over 250% of its operating cash flow (i.e., watch for a distribution cut). United's poor cash flow will probably restrict management's ability to achieve the business plan. Plus, management compensation isn't oriented toward value creation.

Positive market factors include: simple majority voting, fair on-going management compensation and overhead relative to asset value (2-1/2 points awarded because compensation is high relative to cash flow), and 39% management ownership. (Ironically, very high insider ownership can be a negative if it restricts outsiders' ability to take control.)

IN UPCOMING ISSUES

- The Best Energy Investment Strategy To Use
- Getting The Best Price In The LP Secondary Market
- Low Income Housing: The Real Economic Story
- Venture Leasing Deals
- How To Advise Clients With Troubled Investments
- Real Estate Sponsor Performance Comparisons

Unbelievably, picking the bottom and starting a five-year dollar cost averaging investment program at the bottom generates an almost identical internal rate of return -- 19.6% for timing the bottom and 19.2% for the coward's way out, DCA! (See Table 1.)

Now, let's assume you were a genius over the last twenty years and made your entire oil and gas investment commitment the year just before each dramatic rise in oil and gas prices. Table 2 shows the result of "buying at the bottom" versus five-year dollar cost averaging beginning at the bottom.

Only during the dramatic price rise of the 1979-1981 period was "genius" investing, buying in at the bottom, a significantly superior strategy. Most investors would settle for the somewhat lower 23.9% rate of return with dollar cost averaging because: (1) the return is way above average for major asset categories; and (2) most investors know you can't uncannily pick bottoms. Dollar cost averaging produces an acceptable result against the toughest comparison -- buying in each time at the bottom. So, dollar cost averaging will produce better results against all other buy and hold scenarios.

In fact, over seventeen years (1970-1986), a five-year investment program won ten times versus one-shot investing, and produced a slightly superior internal rate of return with about 10% less risk (as measured by standard deviation).

Table 2
DOLLAR COST AVERAGING
VERSUS
BUYING AT THE BOTTOM

Year	Internal Rate Of Return	
	Genius	Dollar Cost Averaging
1970	26.9%	31.4%
1973	37.5%	32.0%
1979	33.2%	15.2%
1986	13.9%	17.0%
Average:	27.9%	23.9%

Note: Methodology same as in Table 1.

DUE DILIGENCE

Revised Roll-Up Report Card

We fine-tuned our roll-up report card (introduced in the December 1990 and January 1991 issues), adding two new tests which give credit for "enhanced investor liquidity" and "better business prospects" for the new entity. The roll-up test now weighs "merger/conversion factors" 65% and "value of resulting securities" 35%.

The roll-ups graded last month are re-scored here -- with only minor changes resulting. Two new deals -- Parker & Parsley Petroleum Company and Public Storage Properties VII -- are reviewed here for the first time. Parker & Parsley, a corporate conversion and merger of a Parker & Parsley MLP and the Damson oil income partnerships is scored two ways -- once for the Parker & Parsley MLP limited partners

(which scores 76% and once for Damson limited partners (which scores 64) -- both passing grades. (The transaction is examined in detail for P&P and Damson limited partners in two special supplements to this issue.) Public Storage Properties VII, the conversion of a single partnership into a REIT, scores an impressive 74 points. (The accompanying article analyzes likely after-market pricing of each transaction.)

ADDED TESTS

We added a test for enhanced liquidity because we believe liquidity ranks at the top of the "wish list" of investors. Investors probably welcome liquidity at any

price. The broker's negative reaction to liquidity for partnership investments is motivated primarily by the pain of seeing clients' assets marked to the market.

Award full points if the roll-up securities are traded and the partnership securities which are rolled-up aren't traded at all. Consider awarding fewer points if the existing partnership's securities trade, and give token points where the securities are already listed on NYSE, ASE, or NASDAQ. Also, give good consideration to transactions which convert partnership interests to REIT or corporation shares because investment interest in the securities will improve.

The second new test is whether the newly formed entity has enhanced business prospects. Examples of enhanced business prospects include: ability to secure financing on favorable terms or raise equity capital; useful diversification of risk; creating critical mass to grow and make acquisitions on favorable terms; removal of a troubled general partner; "trade up" to a more skilled asset manager; or establishment of a new dividend and capital reinvestment policy.

You can see the Box Score on roll-ups/conversions in the market today in Table 1.

Table 1
ROLL-UP REPORT CARDS

Test No.	Fairness of Terms	REAL ESTATE					OIL & GAS	
		Points Possible	CRI/AIM	Public Storage Prop. VII	Berkshire	Milestone	PDP	PDP/Damson
1.	Do you have an affirmative choice of entity?	7	7	0	0	0	0	0
2.	Does roll-up have the same investment objectives as original LP?	5	5	3	3	0	4	1
3.	Does roll-up have same investment policies as original LP?	5	5	5	2	0	5	1
4.	Does management compensation stay the same or decrease?	5	5	5	3	0	0	3
5.	Are partnership expenses reduced?	5	5	0	0	0	5	5
6.	Is exchange value realistic?	5	5	5	0	0	5	5
7.	Is exchange fair to your partnership?	5	5	5	4	4	5	1
8.	Are roll-up voting procedures fair?	4	4	4	1	4	2	2
9.	Are transaction fees reasonable?	5	5	5	5	4	2	0
10.	Is original placing broker/dealer involved?	3	0	1	0	0	3	0
11.	Do existing investors receive tax or tax reporting benefits?	5	5	5	5	0	5	3
12.	Enhanced liquidity?	6	5	5	6	6	4	5
13.	Enhanced business prospects?	5	3	0	2	1	3	5
Fairness of Terms		65	59	43	31	21	43	31

Continued on next page.

Table 1
ROLL-UP REPORT CARDS (continued)

Test No.	Fairness of Terms	Points Possible	CRI/AIM	REAL ESTATE			OIL & GAS	
				Public Storage Prop. VII	Berkshire	Milestone	PDP	PDP/Damson
VALUE OF RESULTING SECURITIES								
14.	Are cash distributions earned?	6	6	6	0	6	6	6
15.	Can current management accomplish the business plan?	5	5	5	2	2	5	5
16.	Does the new entity provide for simple majority votes?	5	0	3	0	0	3	3
17.	Are the new entity's overhead expenses and management fees fair?	5	5	5	4	0	5	5
18.	Does the entity have significant management ownership?	5	0	5	2	5	5	5
19.	Does entity avoid significant conflicts of interest?	4	4	2	0	0	4	4
20.	Has entity's tax status improved or, at least, not changed?	5	5	5	5	2	5	5
Value of Resulting Securities		35	25	31	13	15	33	33
Total Score		100	84	74	44	36	76	64

*Notes: Milestone — transaction involves no soliciting broker/dealer

EDITOR'S NOTE: Subsequent to publication of our original Roll-up Report Card scores in the January issue, United Realty Group's CEO, Robert B. Bruner, informed us that, "I found your Report Card to be a useful tool ... Based in part upon our review of your grading, we made many changes to the terms of our offer." Among the changes: added liquidation feature, reduced expenses and adjusted cash distributions. Upon filing of the amended transaction, The Stanger Report will review and re-score the deal.

IN UPCOMING ISSUES

- "Checkup" On The Health Of Aircraft Leasing Deals
- Low Income Housing: The Real Economic Story
- The Best Way To Buy Real Estate Today
- Getting The Best Price In The LP Secondary Market
- Real Estate Sponsor Performance Comparisons
- Performance Updates For Over 1,200 Partnerships

Senator D'AMATO. Mr. Chairman, may I ask Mr. Errickson a question at this point?

Senator DODD. Sure.

Senator D'AMATO. Given the fact that they have limited capital, they probably couldn't pay many of the partners who wanted to cash in, what do you see as the motivation for this going into these rollups?

MOTIVATING FACTORS FOR ROLLUPS

Mr. ERRICKSON. It's frequently to protect the properties, to pool them, to be able to effect refinancing on the properties which may reduce the debt service obligations and start to produce some more liquidity and cash from the partnerships and to reduce the administrative burden. It should be more cost effective to manage one large partnership than it might be to manage 66 small partnerships which you may be rolling up.

Senator D'AMATO. So are you in essence indicating that it is—there are legitimate reasons for rollups?

Mr. ERRICKSON. Yes, there are legitimate reasons to do it.

Senator DODD. But from whose perspective?

Mr. ERRICKSON. Along the same lines, it might be said that, and I've heard the suggestion that, instead of a total cash out where you make a cash payment of a dissenting shareholder, you cash him out in the form of giving him a note so that as the cash savings are generated from the rollup that you make those payments against the note and, again, that seems to be an idea of more merit but still suffers from the problem that these are highly leveraged and swamped with debt to begin with. And if you add more debt from the standpoint of notes to dissenting shareholders, you've kind of substituted perhaps problems and you may also have a placebo effect that—

Senator D'AMATO. Well, isn't then the other question that you have to ask, if you didn't have the rollup and the partnership would have a value ascribed to it that is not really going to change appreciably one way or the other, that that limited partner is going to find himself or herself in the situation where that \$25,000 investment such as the one Ms. Hooker put in may, indeed, be worth only \$11,000?

Mr. ERRICKSON. Senator, the scenario runs something along these lines—

Senator D'AMATO. Is that right or wrong?

Mr. ERRICKSON. That's correct.

Senator D'AMATO. In other words, it's not the rollup that really constitutes the problem, per se?

Mr. ERRICKSON. That's correct. If I could, there may be three options or so—

Senator D'AMATO. There may be, to use that term which—some excess. I don't want to use "ripoff" but there may be some excess dollars being dollars charged administratively, hundreds of thousands of dollars, general partners et cetera, for the legal work, for the bonding, counsel opinion, et cetera.

But as it relates to the real value in that company, one way or the other, it's not going to be affected by too much, is it?

Mr. ERRICKSON. It isn't. And let me address that specifically. We have looked at the cost——

Senator DODD. That's not your intention to begin with, where you attract—on one hand it's a very attractive and it seems like a very secure way to go. And if you are a small investor and can't understand these things, that's where you're going to end up with these things. But it borders on a ripoff.

Mr. ERRICKSON. That's correct.

Senator DODD. Do you want to comment on that same question? Let me ask Mr. Wollack to comment on that same question. What did you want to——

Mr. WOLLACK. We're hearing the big lie again. I mean, that's what is coming out here. I've been fighting these rollups since they started in the 1980's and every single time when you go to the general partner, they say it's going to be great and we say, just—he talked about to manage the store you need new fees. Just sell the store.

Every single time, every single time, the investors would have been better off selling the store even at a wholesale price than to suffer the fate that I showed you in the chart earlier. This kind of thinking doesn't protect the investors. It's their assets.

The general partners get paid with cash fees, but they are giving us the reasons that they can't pay the limited partners with cash fees up front. I mean this is just, you know, craziness.

Senator D'AMATO. What's the answer, Mr. Wollack?

Mr. WOLLACK. The answer is to put in a series of reforms that protect investors.

The attorneys and accountants who create this kind of a document all of a sudden——

Senator D'AMATO. Can you give to me an example of some of those reforms?

I mean, I'm not against you; I'm with you. But I want to try to hear what reform. We want to save your money. You have a situation, you've invested your money, and you say now they're going to go into this rollup and they're going to eat all this money up with all of the cost to put these documents together, et cetera. Is that what you're saying?

Mr. WOLLACK. I'm saying don't force an investor to go along with the transaction. That's the most fundamental initial reform you can do.

Senator D'AMATO. Don't force him. OK. Now——

Mr. WOLLACK. And that could be structured. It takes a little bit of time and effort, but it can be structured. I don't want to get into too much technical detail here, but you can structure a joint venture between the old partnership and the new entity. Those people who want the new deal, if they think it's so great, they go on the new deal. The investors, like Ms. Hooker and Mr. Rybicki who want the old deal get to keep the old deal.

Now the property is owned jointly between those two entities. When it gets sold, the money goes to Mr. Rybicki and Ms. Hooker according to the original agreement, and pro rata depending on how many people voted for that option. The people who wanted the new rollup option, the money goes to them and it gets reinvested

with all the new fees and everything goes out that way and you get all of the same kinds of benefits they're talking about.

What I'm saying is, the way rollups have been structured do not achieve for investors the results, the promises. You can structure rollups to achieve all of these wonderful promises without causing and heaping the abuse on the investors that's occurred.

Senator DODD. Let me go back now. Let's finish up your testimony. We'll come back.

Mr. ERRICKSON. I'd like to finish up. I'd like to respond, and it goes naturally into my remaining testimony, first with respect to the fees in rolling up partnerships.

We've analyzed all the rollups and we've looked at the fees compared to the asset value. And it ranges anywhere from 1 to 7 percent and, in looking at the nature of the fees, those that you simply can't get away without, certain legal fees and accounting fees and other things that are required and you don't have a great deal of control over, it appears to us that it's hard to rationalize more than 3 percent of asset value, assuming that you have a reasonably sized deal, as being fair and equitable on fees.

So it occurs to us that there is a way of striking some form of measure, whether the front-end fees are equitable or not, on regulating the partnerships. And certainly a deal that has 7 percent of the value of the assets going away on fees to accomplish the reorganization is excessive. And we believe that there should be some kind of regulatory pressure to prevent those levels of fees.

Mr. Wollack has made a suggestion and it's a good one and it applies well in certain cases that there could be options. For example, that a dissenting shareholder simply keep an interest in the old partnership under the old rules and that those who wanted to go along with the rollup go along with the rollup. But again, there are practical obstructions to that type of an idea.

Let's take a real estate partnership. It is now—you have buildings that are owned by two partnerships. You had some that didn't want to go along with the rollup so they own the old partnership and they own a minority undivided interest in a building. And you have some that wanted to go along with the rollup and the rollup was achieved, therefore they are a majority, so they own a majority undivided interest in the building.

Now let's say one of those partnerships has cash reserves and the other doesn't as you go down the line. And the building requires a cash input for tenant improvements or to meet debt service payments because the operating cash is insufficient to meet those payments. You have a conflict of interest between the two partnerships, one of which cannot make a cash contribution toward the building and the other one can. That's a difficult thing to administer and control.

Second, let's say that the owners in the old partnership decide that they'd like to liquidate that partnership and they'd like to sell off their interest and cash out by disposing of the assets. You cannot sell an undivided minority interest in the building. There is no market for it and it would be horribly priced, even worse than the types of prices that we're talking about in the discounts in real estate securities.

There has been a reasonably well-thought-out alternative for mortgage loans done by Bill Dockser of CRI, wherein he rolled up some mortgage loan programs and the investors had an option to go into one of two entities. One was a perpetual life REIT. The other was a liquidating REIT. And the perpetual life REIT's major investment was made in shares of the liquidating REIT. So you didn't have the undivided minority interest problem. All of the loans were owned by the liquidating REIT and the perpetual life REIT owned shares in the liquidating REIT.

We could suggest that you apply that method well toward real estate equity, but then again you run into one problem that makes it practically difficult to do it. In mortgage loans when you sell a mortgage loan and you buy a mortgage loan, the fees and costs of selling and buying are rather low. When you sell and buy real estate, the fees are very high. So the perpetual REIT suffers from the standpoint that it pays fees on the sale through its ownership in the liquidating REIT of the assets and then it must reinvest. And when it does, it incurs the fees again and on an investment dollar can start to take 6 to 12 percent in fees under that scenario.

Senator DODD. I'm going to ask you sort of wrap up here. We've got the Chairman of the SEC waiting and I don't want to—

Mr. ERRICKSON. I'm nearly done at this point.

Senator DODD. It can get rather technical here and I think you're going to have some eyes start to glaze over. We can accept that as it—

Mr. ERRICKSON. The other point on a cramdown is that only about 75 percent of shares vote. So when you get a 51-percent simple majority vote, you're required to get about 70 percent yes votes from the voting shares. So the cramdown may be a little less close than it sounds in the voting and the number of dissidents may be a little bit less than it would otherwise appear.

But in conclusion we essentially agree with what we've heard today with the caveat of care in what's done so that additional damage isn't done through legislative action.

We believe that some new NASD regulations to present abuses would be in order along the lines of the abusive practices that I defined earlier. And we agree that new SEC disclosure and summary formats in particular are in order to make these transactions more discernible. And we think certain things like longer periods of review before investors are required to vote and other practices would be very helpful to the industry and would do a great deal.

I would like to make one final comment in that the press that's covered these issues and the actions of the Congress seem to have been taking some effect because as we follow recent rollups they are coming out a lot better than the old ones were. So, to a certain extent, even the efforts exerted by Congress to this point have had their influence in the marketplace and market factors have been serving to clean up rollups and make them somewhat better than they were previously.

Senator DODD. I appreciate you saying that. Because, again, it's axiomatic. But if there is general consensus that the role of the small investor is extremely important in capital formation and the stability of our markets, liquidity of those markets, then clearly this kind of a story is one that has a chilling effect on that very

constituency that we're trying to draw back in after the market breaks of 1987 and 1989. It's extremely important that that investor have some degree of confidence in the system generally. And certainly, as has been pointed out, the worst thing we could do, of course, is to discourage the small investor from coming into the market. I mean, that's vitally important. And I don't want to see limited partnerships wiped out because they can play a very valuable role.

And, obviously, when people put their money in investing, there is a risk involved in that. Now what you choose to invest it in obviously raises or lowers the risk that you have to assume to be a part of it. But, clearly, when you have some things done here that just are so discouraging and send such a dreadful signal out there, particularly that crowd of the \$8,000, \$10,000 and \$12,000 range or, in the case of Ms. Hooker, size \$25,000. But you see the average in these States hovers around \$10,000. And that person just says, look, I'm not getting anywhere near that business. I'm just not getting anywhere near it. I'm going to run elsewhere. I'll go someplace else and do it. We all suffer terribly from that.

So I hope that, in effect, some of these things can be done by just regulatory changes. I'm not anxious to see legislative action if it can be avoided. I would rather have it done through regulatory reforms that are changes.

We will hear from Richard Breeden and others shortly as to whether or not that can be done. If legislation is necessary, we will move in that direction.

Let me—I've got some questions for you, Ms. Hooker, and for you, Mr. Rybicki. But I want to quickly get to Mr. Stanger—Mr. Errickson and Mr. Wollack.

Mr. Wollack, you—the problems of watching those drops, that earlier chart you had, the first day and then the overall value, I think on the average are losing approximately 45 percent of their exchange value, if you will, in the first day, the first 24 hours.

Mr. WOLLACK. This chart was just real estate. That which you refer to combines all rollups.

Senator DODD. I understand. We looked at some of the other ones. The Sentinel Group rollup lost 31 percent in the first day. The National Realty lost 60 percent. Concord Milestone Investors lost 72 percent. Hallwood Realty lost 78.3 percent in value. So some, obviously, are lower. But still a staggering figure.

But the question is, what's going on here? I mean, someone is either making some dreadful appraisal mistakes, or something else is going on. One might understand 5, 10, 15 percent, 20 percent even in some cases, those things happen, even some that are much larger. But when you get a consistent number as high as that is, to the layman anyway, as I look at it, it appears as though there's some dreadful miscalculation in terms of the value of these assets and I wonder if you might comment on it.

And then I'm going to ask you to do the same thing, Mr. Errickson.

Mr. WOLLACK. I appreciate Mr. Errickson's sensitivity to the problems, but there is some information that hasn't been communicated in the testimony here today and that is that the reason these

securities don't perform well and perform so poorly is the fact that once you roll them up—

Senator DODD. Just before you get to the rollup, are the general partners putting an inflated, a hugely inflated value on these assets to begin with and maybe what we're looking at is a more realistic value?

Mr. WOLLACK. I don't necessarily believe so. We've got a problem if they are. Then they are committing fraud in terms of what they're disclosing in their prospectus. I'm just using their numbers. This is what they say the real estate's worth and what the appraisal says the real estate's worth. So either they are committing fraud or I have added my numbers incorrectly and I have doublechecked, my numbers.

The point is, and our analysis shows, that in some cases we might differ on a given property. We might think it's worth more or less, et cetera. Sometimes there are incentives to lower the valuations, not to overly inflate the valuations, and I won't get too technical for why that might occur.

But the point is, I have to accept something that is given to me as an appraisal. Cushman and Wakefield did the Hallwood-Equitec appraisals. I know the head of property appraisal for the national firm of Cushman and Wakefield. I think this is a man of highest reputation and honor. I don't believe he's putting in false numbers.

So I think what is causing this is not the fall from the appraisal of the real estate value. I think the real estate value is there. What is causing these phenomenon is that you've created a junk security, a security that does not perform like other real estate securities.

And if I may show you one chart for example—David do you have that other chart? It should be turned around. It's the last one. Just turn it around.

REIT's, which are the equivalent of rollups after they have been rolled up, REIT's in the last 3 months have had a significant rebound in terms of performance because people are perceiving that this is the time to be buying real estate, they are undervalued, et cetera.

In the 3-month period, November, December, January, they were up 14.8 percent, better than the Standard and Poor's, which has done pretty well in that same period also.

The equivalent of it, all of the real estate rollups that we have analyzed during that same exact period of time, lost 20.2 percent. Now I can only explain that there is something wrong with the security. It is the fact that the general partners have super majority voting privileges so that they require 66%, or 75 percent of the limited partners to vote them out, allows for selfdealing. No securities analyst in his right mind recommends securities where they have entrenched management like that that aren't subject to the possibility of someone coming in and kicking him out. They've blended good assets with bad assets.

You cannot take two \$5,000 dogs and make a \$10,000 cat. You have got to have something of value, real value, if you are going to get the benefit of this rollup theoretically. And the value is taking the good assets propping up the bad assets. Unfortunately, the bad assets should be let go.

And I respect your comments in the opening statement, Mr. Chairman, that if an investor got in a bad deal, we're not here to protect him from that; that's not what we're talking about if they are in the bad deal. Those bad deals should be let go. If those bad assets can't hold onto themselves, they should be let go. They are not the ones that are going to continue this ability for this new entity to go on and do a good job for the investors. It's the good investors.

Ms. Hooker was in a fabulous partnership. It was her assets that were used to prop up assets that never should have been saved. And they created junk security that no one wants to own, and that's why you have this performance and that's why during the decade of the 1980's, REIT's appreciated 85 percent. Real estate rollups dropped 84 percent.

Senator DODD. Mr. Errickson, do you want to comment on that?

Mr. ERRICKSON. I do. The sad reality is that whether you have a rolled up entity trading in the market, whether you have a partnership that hasn't been rolled up trading in the market, whether you have a REIT trading in the market, or whether you have a corporate stock for a real estate operating company trading in the market, they all trade very badly because, currently, there is very little confidence in the securities market in real estate.

I have testified and the facts support it that there are deep discounts to appraised value in partnership securities that have not been rolled up, in partnership securities that have been rolled up, in REIT's and in corporate stocks involving real estate transactions.

The simple reality is that the market prices real estate securities on yield, and it looks at the cash that's being distributed out of those units and it determines the price from that and it doesn't make any difference what security form it is, it essentially trades them on similar type yields.

I agree with Mr. Wollack's comments that if you have an abusive rollup and you have super majority voting provisions, the market will demand a higher yield for that because it does not like the management control over the security and the fairness of management to the investor and it will demand a higher yield which means a lower trading price.

But inherently, if you eliminate the abuses in rollups, rollup securities will trade the same as REIT's, rollup securities will trade the same as corporate stocks involved in the same assets.

The reality is you have a depressed real estate market and in the 1970's when you had the last case, you had tax incentives to induce buyers to come into the market to uphold it. You don't have those kinds of tax incentives today and you have no way of luring investors. And what the securities market is saying is that the real estate market is going to remain depressed for a while, we anticipate declines in earnings, we don't believe that appraisals are going to be realized, we don't think you can liquidate assets at appraised values, and therefore we are discounting the securities. And they don't care what form it's held in, whether it's rolled up entities or REIT's or corporate stocks. They are punishing all of those different securities.

DIFFICULTY IN APPRAISING ROLLUPS

Senator HEINZ. Mr. Errickson, let me jump in. I apologize to the witnesses for not having been here at the commencement. I had two other hearings this morning, as happens occasionally. I just want to be clear on one thing.

Mr. Wollack gave us the example of an investment, one that Ms. Hooker apparently went along with, where a good limited partnership, hers, was rolled in with some apparently worthless ones, somebody else's. She went along with that on the advice of her broker, as I understand it, but how is she to—

Senator DODD. Even if she had not, it would not have made any difference.

Senator HEINZ. Yes. She was going to get rolled over.

Senator DODD. Rolled up. [Laughter.]

Senator HEINZ. Rolled over, along with rolled up just as was Mr. Rybicki. My question to you is: In the case of somebody who was trying to analyze these things, why can't they figure it out?

Would you have been able to tell Ms. Hooker, or investors in Ms. Hooker's position, that this was not a smart thing for them to do? If so, why didn't people advise investors? And if these investors weren't advised properly, what is the problem?

Mr. ERRICKSON. I think a good real estate analyst and securities analyst may have been able to do that, but again I suggest that it is real estate market factors and securities market factors that have caused the loss—

Senator HEINZ. I am not interested in that. I am interested in a real simple proposition. She apparently had, by real estate standards, a pretty good investment. It was rolled in with, I gather, some pretty bad investments.

I am not asking what the market is doing. We all know the market is terrible. So could you please take another crack at it?

Mr. ERRICKSON. I have two comments on that.

One is—

Senator DODD. Let me add a question to ~~that~~, because in the January 1991 Newsletter, the Stanger Report, you advise your readers on the negative aspects of the six rollups that you reviewed.

Mr. ERRICKSON. Yes.

Senator DODD. Of those six rollups, your analysis gave four of the rollups flunking grades.

Mr. ERRICKSON. That is correct.

Senator DODD. What you call "flunking grades" on the rollup report card.

So it might be interesting, just in light of that, because you do analyze.

Senator HEINZ. I mean, you obviously know this stuff cold.

Mr. ERRICKSON. We are definitely positive for reform. Again, my comments are just trying to direct the nature of the reform and not to oppose reform.

Senator HEINZ. My question is, how is an investor—let us assume—

Senator DODD. They read your report.

Senator HEINZ. Well, let us assume in fact that Senator Dodd and I and Senator D'Amato are the only three Senators who care about this.

Congress does not act, but still have a problem.

The question is: All right, there are some other hypothetical Ms. Hookers out there.

They want to make an informed judgment.

There seems to be evidence that it is very difficult to do that.

What should they do?

APPRAISAL PROCESS AND FAIRNESS OPINION

Mr. ERRICKSON. If I could make two comments, though, on the issue of a good partnership presumably being merged with bad partnerships, and that being a bad thing?

Senator HEINZ. Yes.

Mr. ERRICKSON. The purpose of the appraiser is not to set an exchange value.

That is set by the investment banker.

It is not even set by the appraiser, and the appraisal is to make an equitable distribution of shares between investors in the different constituent partnerships.

So he is supposed to adjust on the merits of her good partnership and on the bad merits of the other partnerships, that she gets a larger share in the total pie as a consequence of having a superior partnership.

Then there is a second level of protection that exists in the rollout currently.

After the appraiser has done his work to determine that Ms. Hooker's partnership was worth more, therefore she should get more shares, an investment banking firm steps in and issues a fairness opinion in which they look at the terms and conditions of the transaction and the appraisal and renders an opinion that they believe that things were done equitably.

This is what the system has provided to attempt to protect against good partnerships going with bad.

I am not sure that it works always, and sometimes good partnerships turn bad and bad ones turn good, so you are never quite sure of what is going to happen in the future anyway.

But there is a mechanism through the appraisal process itself and the fairness opinion requirement to attempt to protect Ms. Hooker and see that she gets an equitable number of shares in recognition of her good partnership.

Senator HEINZ. We want to get Chairman Breeden on, but let us say you have got one partnership where the cash flow is positive.

You have got another partnership where the cash flow is quite negative. And let us say Ms. Hooker gets 100 percent equity in the new merged partnerships.

What she had before was a partnership with a substantial value.

Even if the people who had the partnership which was losing money get totally diluted out and remain with a zero interest, she gets something that is not as good as she had before.

She has got a turkey, along with a golden goose, and the result is that the goose has to subsidize the turkey and that's a bird of a different feather worth only a fraction of what it was before.

How can any adjustment of values solve that problem?

Mr. ERRICKSON. Senator, there should be no ability, if there is a negative cash flow, there should be no ability to find some worth on the appraisal unless there is a turnaround potential on the property.

Then if the property turns around, she would share, theoretically, significantly in that upside.

So again the only comment I can make is, the only mechanism for it is the hope that the appraisal process and the fairness opinion process works and makes the appropriate adjustments.

Senator HEINZ. May I ask this? Did any of the so-called "not so good partnerships" that have been merged in these rollups, have negative cash flows?

Mr. ERRICKSON. I am sure that is true, Senator.

Senator HEINZ. Do you think a fair number of them had negative cash flows?

Mr. ERRICKSON. I would say that a fair number of them may have, yes.

Senator DODD. Did any of them ever get any better?

Mr. ERRICKSON. Yes, some of them have, and some of them have gotten worse.

Senator DODD. What percentage of these? Just give me a rough, ballpark figure.

Mr. ERRICKSON. I could only speculate, Mr. Chairman.

Senator HEINZ. Go ahead.

Senator DODD. Go ahead. I mean, what the hell? [Laughter.]

Senator HEINZ. You are doing the speculation, not us. [Laughter.]

Mr. ERRICKSON. Based on the way the real estate market is going, you would certainly think more of them are worse than better, because it has been a continuously declining market.

Senator DODD. Are we talking a fraction? Five, ten percent? Fifty percent?

Mr. ERRICKSON. I really could not even attempt to speculate that closely.

Mr. WOLLACK. The sadder thing is, Ms. Hooker's good properties have gone worse, also, because they do not have the cash to support them and put back into maintaining those properties to the highest level.

That is the sad part of it, they all go down and that is why you have that kind of performance.

Senator DODD. I would like you to stay around maybe a little bit.

We have got Richard Breeden who has to catch a flight, and he has very graciously been waiting for about half an hour here.

We have not even really begun to explore it. I did not get a chance to ask Ms. Hooker any questions, but if you will stay around a little bit we will come back to you if we can, although we have another panel, as well.

I apologize. There is so much to get in on this, but it has been tremendously helpful to hear your testimony here this morning.

Do you want to comment just on what you have heard so far? What do you do for a living, Mr. Rybicki?

Mr. RYBICKI. I am a caseworker. I am a clinically oriented social worker, and I work in the school system.

I have been employed there in the Van Dyke School System in Warren, MI—

Senator DODD. For how long?

Mr. RYBICKI. For 14 years.

Senator DODD. And how about you, Ms. Hooker? You said you work?

Ms. HOOKER. Yes. I am currently employed as an employee benefits professional, specializing in pension and 401(k) plans.

Senator DODD. Well, that is pretty esoteric stuff.

I mean, anybody who can understand that stuff—

[Laughter.]

You can explain ERISA to me? [Laughter.] -

And you cannot read a prospectus? [Laughter.]

Come on, now. Why do you not just comment on that.

Ms. HOOKER. I did not do that in 1978.

Senator DODD. OK.

Mr. RYBICKI. My comment was I think that the issue, as I listen here, becomes rhetorical and misses the point.

The point was, I did not want any bailout programs in what I bought.

Had any suggestion of bailout entered, I would have put my money in the bank and we would be talking about nothing here today.

I would not be here today.

I do not think a blending of programs to bail out other entities involved in that corporation justify me taking a hit, and so large.

I am really not much interested in those entities, the other ones that the company is involved in, plan B, C, D, and E.

And when you change from a finite program to an infinite one, they drag in everything over time, I obviously am not going to be attuned to that and I leave that for the experts.

But I am the risk-taker.

And had you come up front to begin with with all of these possibilities, I would have been walking a long time ago because, as far as I am concerned, they were not at all what I wanted.

You know, I am a little more familiar with multifactorial designs in psychology.

Any time you have cells that have very little frequency, you collapse over them because they do not account for very much variance.

Well, I see that kind of pacification being the justification here for a rollup, and somehow that in some cases a rollup is justifiable.

I will leave here not feeling that that is accurate.

A rollup is a rollup is a rollup, and I think they are all dogs.

Senator DODD. Well, you are shy anyway, Mr. Rybicki. [Laughter.]

Senator HEINZ. I would call it "skeptical."

Senator DODD. Skeptical, yes.

Ms. Hooker, do you want to comment at all on what you have heard so far? Pull that microphone forward, if you would.

Ms. HOOKER. I would agree that I would prefer not to see rollups, as Mr. Wollack says.

I had a good partnership, and I am sure if I still had it, it would still be a good partnership.

I would prefer to see no rollups at all.

I agree again with Mr. Wollack's comment, to sell the store if need be.

If there are going to be rollups, I think further dissenting rights of some sort or another are necessary.

I may understand ERISA, but I do not understand all of these, but some sort of dissenters' rights or alternative propositions have got to be available to long-term investors who are in there for capital appreciation.

Senator DODD. OK. Well, thank you all.

Thank you very much, all four of you. We will either try and get you back up, or submit some written questions to you here to follow.

You have been very, very helpful, and I do want to thank you, Ms. Hooker and Mr. Rybicki.

It is not particularly easy to come forward here and talk about these things.

As I said at the outset, it always helps. We listen to the industry. We listen to the regulators.

It is always refreshing to have someone come forward who are the people we always are talking about, and that is the investor.

So we appreciate your willingness to be here this morning and we will follow up with you.

Thank you all, very much.

Our next witness is the Chairman of the Securities and Exchange Commission, and we are deeply appreciative, knowing his busy schedule, for being here with us this morning to comment on the subject matter before us.

Where is the Chairman? He is here?

Mr. Chairman, we thank you for once again gracing us with your presence.

Mr. Chairman, we thank you for being with us this morning.

I do not know whether you have had an opportunity to hear or peruse the testimony of Mr. Errickson from the Stanger Report, or Mr. Wollack, as well as to hear, or at least to get some feeling for our two investors who were here with us this morning who had bad experiences with the subsequent rollup of their limited partnership.

But we are very anxious to hear your comments here this morning as to what, if any, suggestions and ideas would make any sense in terms of trying to build some investor confidence with these smaller investors that we have talked about in the past and the important role they play in our capital markets.

So I thank you for being here with us this morning.

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman BREEDEN. Thank you, Mr. Chairman.

I am certainly happy to be here today to discuss what, as you just noted, is a very important issue: the protection of investors, and particularly in this case as in many cases the small investors

participating in limited partnerships, and particularly the transactions generally referred to as "rollups."

During the 1980's, approximately \$150 billion worth of limited partnership interests were registered for sale to the public with the Commission.

I would emphasize that the amount actually sold is probably less than the amount registered, but nonetheless that figure gives an idea of the significance of the level of investment in limited partnerships.

These are investment vehicles in which literally millions of people have invested in across the country, and consequently are a matter of legitimate and considerable concern.

In addition to those publicly registered limited partnership units, tens of billions more in privately placed limited partnership units were also sold during the 1980's.

A rollup, as you know, is a significant consolidation of the original limited partnership with other limited partnerships into a single entity whose securities often are traded in the public market.

Since 1985, 65 rollup transactions involving approximately 1,200 entities with an aggregate exchange value of about \$6.9 billion have been registered with the Commission.

Just as a frame of reference that is not intended to diminish the significance of the rollup transaction, but in that same period of time with about \$6.9 billion in exchange value of rollups, we have had about \$450 billion in tender offer transactions on the corporate side, which raise some of the same kinds of issues.

A limited partner in some respects is certainly similar to a common stockholder in a corporation.

Like a stockholder, a limited partner does not have any direct role in management or any liability for debts beyond the value of his or her partnership interest.

Also much like corporate directors and managers, the general partners who manage the partnership under State law have some form of fiduciary duty to their limited partners.

One of the main differences between corporations and limited partnerships of course is their tax treatment. Income to a corporation, regrettably, is taxed twice, once at the corporate level and again when the shareholder receives dividend income.

However, there is no separate tax on partnerships so that partnership income, losses and deductions attributed directly to individual partners flow directly through to the limited partners.

Because of their favorable tax attributes, limited partnerships have been widely used as investment vehicles, particularly in industries that qualify for special tax benefits such as oil and gas and real estate.

Many limited partnerships were in fact structured largely to take advantage of favorable provisions of the Federal Tax Code, although I might also hasten to add that not all partnerships were tax-driven deals, and many partnerships were in fact structured without tax motivations as a principal feature.

After the changes in the Federal tax law in 1986 and 1987, and with the decline in the real estate and the oil and gas industries that happened around the same time and subsequently, many of

these limited partnerships interests have lost a great deal of their value.

Rollup promoters have tried to convince partners that these transactions will help salvage some of this lost value, and often hold out the promise of creating some liquidity for limited partners who often have virtually complete illiquidity in their existing instruments.

However, despite these promises, the only certain result of a rollup is very high fees charged to complete the deal, and usually even higher fees to the new entity when the rollup transaction is finished.

Rollup transactions have been criticized because of the alleged inadequacy or incomprehensibility of the required disclosure, the practice of paying brokers fees for obtaining affirmative votes from investors, and perhaps most importantly, the fundamental fairness of the transactions to limited partners.

Based on the seriousness of the concerns that underpin these criticisms, I have asked the Commission staff to undertake a review of all the rollup documents filed with the Commission since 1985, including those now pending, and any filed in the future with a view to defining disclosure practices that would serve to enhance the required disclosure, while requiring it to be more comprehensible to investors.

And I would add parenthetically, Mr. Chairman, I have taken a look at some of the documents filed with us in these rollup transactions and I would like to meet the person who can understand all of the disclosures in some of those documents.

I think we have not done as much as we should have done to make sure that registrants file not only a document that contains all the correct disclosure, but that is actually readable and comprehensible to the people getting that document.

Guiding this review of the disclosure requirements, and consistent with the Commission's traditional mandate under the Federal securities law, is the vital goal of assuring that rollup disclosure provides investors with adequate and understandable information to assess the merits and the risks of a rollup transaction, and the interest of the sponsoring general partner in its successful outcome.

Among the actions that we will consider in connection with this review are:

Enhanced disclosure of valuation methods used to determine the value of the limited partner's interest to be exchanged for new securities;

Disclosure of liquidation values;

Comparative historic and pro forma fee disclosures so people can see clearly how much money was taken out of the old entities by the general partners, and how much money will be taken out of the new entities;

Extension of solicitation periods where they may be unduly compressed in time;

Access to limited partnership lists for persons conducting a regulated proxy solicitation;

Going-private-type disclosure, including disclosure as to the fairness of the transaction; and

Comparative historic and pro forma cash flow information.

I would add that these are issues which we will consider, and I do not obviously prejudge the outcome of that consideration nor in this respect speak for the other Commissioners, each of whom will have to have an opportunity to evaluate the results of this review before any rulemaking actions would be taken.

The practice of compensating brokers on the basis of the number of "yes" votes that they obtained from investors in a proposed rollup also raises important concerns, and I am particularly concerned in this area personally.

The Commission believes this practice ought to be reviewed carefully to determine whether it undermines the efficacy of the disclosure system and therefore should be restricted.

At the Commission's suggestion, the National Association of Securities Dealers has proposed to its members an amendment to its Rules of Fair Practice that would prohibit these compensation agreements that are contingent on getting a "yes" vote.

I understand that comment has been largely supportive from the membership on that proposed amendment, and if the NASD formally proposes it to the Commission I can assure you that it will be scheduled very promptly for Commission consideration.

However, the fundamental concerns raised about rollups focus on the basic fairness of the transactions, in addition to this solicitation question.

These concerns derive from the potential overreaching by the general partners inherent in the increased benefits accruing to them in most rollup transactions.

These benefits take the form of the allocation of greater equity interests in the surviving entity, and the payment of enhanced fees and other types of compensation.

These transactions also frequently result in the imposition of super-majority voting provisions in the rolled up entity governing investors, removal of the general partner.

These factors, coupled with the general lack of State statutory appraisal rights and the inability of investors opposed to a rollup to sell their partnership interest into an extremely illiquid market, heighten the perception of unfairness that many investors feel about these transactions.

Under State law, general partners owe varying degrees of fiduciary duties of good faith, loyalty, and due care to limited partners.

It is not clear to the Commission why State partnership law has not evolved to the point that general partners feel compelled to adopt procedures comparable to the independent committees of corporate directors establishing their fulfillment of fiduciary obligations in a tender offer or merger transaction where you have many of the same issues of duties of care, duties of loyalty and fiduciary concerns for directors and officers.

And it would appear that in the tender offer or merger context, where you are dealing with shareholders of a corporation, that the insiders make more considerable efforts to try and involve independent parties in resolving some of these questions as a protection against lawsuits than general partners seem to feel that they need to do in order to avoid the same kind of lawsuits that often are filed on the corporate side.

These duties, both in the corporate case and in the partnership case, are duties that arise under State law, and they are duties that ultimately are vindicated by shareholder or partnership suits.

Yet it would appear that, at least in most States, the effective duties imposed on corporate officers and directors appear to have a much stronger underpinning of case law than exists at least so far in the partnership area.

I cannot fully explain to you why what should be; similar sorts of duties have been interpreted to give at least the appearance of greater latitude to partnership insiders compared to corporate insiders. One reason may be that mergers or other business combinations involving partnerships have only recently been allowed. Traditional hornbook partnership law back in the ancient days would have just simply not allowed mergers. Partnerships did not engage in mergers; corporations did.

Over the last number of years, there has been a wave of what is characterized as modernization of partnership laws in which things like mergers are permitted, but the evolution in the statutory structures has somehow not been matched by evolution in the level of duties to the limited partners.

I should note that New York, California, Maryland, and the District of Columbia have led the way in adopting statutory appraisal rights similar to those provided by State corporate law.

It is an inescapable fact, however, that investors flock to limited partnership vehicles in the expectation of enjoying the pass-through of tax benefits, deducting on their own tax returns a share of the partnership's interest payments on its nonrecourse debt, while having the safety of limited liability enjoyed by investors in corporations.

All too often, despite the disclosures of the original offering document, these investors have been shocked to find out just how limited are the substantive rights of limited partners under State law.

Many of the protections for the shareholder voting franchise which investors have come to expect of listed companies, such as one share/one vote—and I might add that I wish that the expectation that shareholders in corporations would actually get one share/one vote would be vindicated more frequently in practice—but at least I think it is a common perception of shareholders that they will have very adequate voting rights.

And in the partnership case, I think many times when this issue arises limited partners are shocked to find out that they do not have nearly as extensive voting rights as may exist in the corporate area.

Consider the provision of the Delaware Revised Uniform Limited Partnership Act, and I quote:

A partnership agreement may provide for the taking of an action, including the amendment of the partnership agreement, without the approval of any limited partner or class or group of limited partner, including an action to create under the provisions of the partnership agreement a class or group of partnership interests that was not previously outstanding.

Now that is a blank check for the general partners to restructure the partnership any way they want without a vote of the partners. That same power generally would not exist in the corporate area where we are dealing with the publicly traded corporation. That

again is a difference between the Delaware corporate law and the Delaware partnership law, and it is not a matter of Federal securities laws. Although many publicly offered partnerships provided for limited partner approval based on an affirmative vote of a majority of outstanding interests, voting rights are now being in many cases restricted through the rollup device through the imposition of super-majority voting requirements.

It is precisely this assault on investor rights in the rollup area so disturbing to many of us that the Commission has opposed the proliferation of State antitakeover legislation.

I might just add, parenthetically, Mr. Chairman, that I personally believe very strongly that we have allowed the process in the States to go much too far in attacking the basic voting rights of shareholders. We have things like the proxy process because we believe shareholders ought to have a right to vote, and that there ought to be some protections for that voting process, and that the vote should be meaningful and conducted in a manner that is realistically available to the shareholders, and that we should not allow corporate insiders to concoct structures that have the practical result of frustrating the right to vote. We have seen a very significant, meaningful, and quite adverse erosion of shareholder voting rights in this country. I have been trying to speak out about that, in opposition to some of the most egregious State laws, and some of the corporate actions taken thereunder.

Just barely a week ago, for example, a committee of the American Stock Exchange proposed to its directors to allow differential voting rights in listed companies, which is a sharp break from the position of the NASD and the New York Stock Exchange which parallel the Commission's earlier attempt to establish the principle of one share/one vote by rule, which I think wrongly was struck down in the courts.

But the American Stock Exchange again is taking some actions paralleling that going on in some of the States that have the impact of steadily undercutting the rights of shareholders to vote. I do not like it in the corporate area, and I do not think it is right in the partnership area, either. Nonetheless, it is important to emphasize that the State partnership law does impose fiduciary obligations upon general partners that, if violated, can be redressed by investors in the courts. Indeed, we understand that litigation has been brought in connection with some of the recent rollups. However, in many cases these suits are settled and we do not see a reported decision that might encourage other similarly situated limited partners to bring similar suits.

Because State partnership law charges the general partner to act as a fiduciary for the limited partner, for the general partner to overreach and advantage itself to the detriment of the limited partners is a violation of those fiduciary duties and should be actionable under the State law.

The Commission has ample authority and does rigorously review the disclosure provided in rollups to assure that investors are fully informed of all matters relating to the fairness of the transaction, and the general partner's compliance with its fiduciary obligations.

In addition to mandating complete disclosure regarding rollups, the Commission's rules are designed and enforced to protect inves-

tors against securities fraud in connection with these transactions. A basic principle, however, of the Federal securities laws is that it is the investor, not the Government, who must in the end make the fundamental determination based on full and fair disclosure required by the Commission of whether a particular transaction or investment is good or bad.

In conclusion, the Commission understands the criticism and frustration regarding rollups, and indeed in some areas we share much of that frustration. Of course no one can simply restore the lost tax benefits or the loss in value that in many cases has contributed materially to investor displeasure regarding rollups. Both through its review of particular rollups and through its general review of disclosure for rollups, the Commission will attempt to ensure that investors receive complete and comprehensible disclosure, and that all requirements of the Federal securities laws, particularly antifraud provisions, are fully observed. The Commission remains dedicated to ensuring that investors receive the disclosure that they need to make their own informed decisions about rollups.

Thank you.

[The complete prepared statement of Richard C. Breeden follows:]



TESTIMONY OF

**RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION**

CONCERNING "ROLL-UPS"

**BEFORE THE SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE**

FEBRUARY 27, 1991

**U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549**

TESTIMONY OF
RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION
CONCERNING ROLL-UPS
BEFORE THE SUBCOMMITTEE ON SECURITIES
OF THE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

FEBRUARY 27, 1991

Chairman Dodd and Members of the Subcommittee:

I am pleased to be here today to discuss issues relating to reorganizations of limited partnerships, generally referred to as "roll-ups."

I. Introduction and Summary

Interests in limited partnerships have allowed many individual investors a way to participate in real estate, oil and gas, and other industries, with substantially the same tax treatment as direct investment. With the significant changes in the federal tax laws in 1986 and 1987, and with the difficulties in the real estate and oil and gas industries, many of these limited partnership interests have lost much of their value. A roll-up, the consolidation of several limited partnerships into a single new entity, is often proposed as a way of providing limited partners with a market for their interests through an exchange listing. Roll-ups have also been promoted as a way of salvaging for the limited partners some of their investment.

Unfortunately, although roll-ups of limited partnerships are in economic terms similar to mergers of corporations, there are some important differences between state corporate law and state partnership law. In part because of these differences, some of

the procedures and protections common in corporate mergers are absent in roll-ups, and conversely there are aspects of roll-ups that are unusual in corporate practice. It is possible, for example, as part of a roll-up, to increase the vote required to remove the general partner from simple majority to super-majority. Limited partners have been particularly and understandably unhappy when what they consider fundamentally unfair transactions are proposed by their general partners, who owe them state law fiduciary duties. In considering the problems of roll-ups, therefore, one needs to consider state partnership laws, as well as the federal tax laws and economic conditions, which have all led to roll-ups.

The Commission's role, under the federal securities laws, is to assure that roll-up disclosure provides investors with sufficient and comprehensible information to assess the merits and risks of a roll-up transaction and the interests of the general partner in its successful outcome. The Commission is also concerned about the practice of compensating brokers on the basis of the number of votes they obtain in favor of a roll-up. At the Commission's suggestion, the National Association of Securities Dealers, Inc. ("NASD") is reviewing this practice in light of brokers' fiduciary duties in making recommendations to their customers.

The Commission has undertaken an in-depth review of the adequacy of its requirements applicable to roll-up transactions. Among the actions being considered

are:

- enhanced disclosure of valuation methods used to determine the value of limited partners' interests to be exchanged for new securities in the rolled-up entity;

- disclosure of liquidation values;

comparative historic and pro forma fee disclosure;

extension of solicitation period;

access to limited partnership lists for persons conducting a regulated proxy solicitation;

going private type disclosure including disclosure as to the fairness of the transaction; and

comparative historic and pro forma cash flow.

Under the federal securities laws it is the investor, not the government, who must make the fundamental determination of whether a particular roll-up, like any investment, is a "good" or "bad" transaction. The securities laws are intended to make certain that the investor is provided all material information so that he or she can make that decision on a fully informed basis. This includes information bearing on the merits of the transaction, the interests of the general partner therein, the resulting change in the investor's rights, and the business, prospects and risks of the new entity.

II. Background On Limited Partnership Offerings and Roll-ups

A. Limited Partnerships

Both the rights and responsibilities of participants in limited partnerships are governed by state partnership law, which generally provides that one or more general partners manage the business of the partnership, while one or more limited partners contribute capital.

A limited partnership interest in some respects is similar to owning stock in a corporation. Like a stockholder, a limited partner does not have any direct role in management of the entity, or liability for the partnership's debts beyond the value of his or her partnership interest. Also, much like the relationship between corporate directors

and managers and the shareholders they serve, state law generally imposes fiduciary duties to limited partners on general partners, who conduct the **actual management** of the partnership's business.

One of the most important differences between corporations and limited partnerships is their tax treatment. Income to a corporation is taxed twice -- once at the corporation level and again when the shareholder receives dividend income. However, partnership income and losses are attributed directly to the partner, avoiding any separate tax at the level of the partnership itself. Thus, income in a partnership is taxed once rather than twice, and deductions or losses of the partnerships flow directly to individual partners.

Due to the tax attributes of limited partnerships, they have been widely used where the underlying business activities have significant tax benefits that can be passed along to limited partners. Many limited partnerships were in fact structured in recent years in significant part to take advantage of favorable provisions of the federal tax code.

Limited partnerships afford individual investors the opportunity to invest in commercial and residential real estate, oil and gas drilling programs, cable franchises, motion pictures or plays, or other tax-advantaged properties, and to receive substantially the same tax treatment and cash distributions as a direct investment in the property itself would provide. 1/ This allows investors who do not have the individual expertise,

1/ Another type of limited partnership that has been publicly offered in significant numbers in recent years is the commodity pool limited partnership ("CPLP"). While the CPLP uses the limited partnership structure, its method of operation distinguishes it from the other partnerships listed in the above text. A CPLP is primarily a trading vehicle.

who cannot afford, or who do not wish to risk the funds necessary to finance entirely a particular property, to obtain the benefits of direct ownership of the partnership's assets by pooling capital with other similarly situated investors.

A significant attraction of limited partnerships prior to major revisions to the tax code beginning in 1984, when many limited partners made their initial investment, was the pass-through of tax benefits available because a partnership was not treated as a separate taxable entity apart from its investors. Reliance on partnership financings in industries like oil and gas, real estate and equipment leasing reflected the availability of such further tax incentives as accelerated depreciation, depletion and amortization, which typically permitted the realization of passive losses from the investment.

With the adoption of the at-risk limitations for oil and gas programs in 1984 and, thereafter, the passive loss rules, lower tax rates, elimination of capital gains treatment and other provisions of the Tax Reform Act of 1986 and the Revenue Act of 1987, the tax shelter and other tax benefits of limited partnerships were substantially reduced. Consequently, after-tax returns expected for many such partnerships formed prior to these tax changes were significantly undercut. The change in tax treatment came as the oil and gas industry was in the midst of a significant recession, and immediately before the commercial real estate market began to weaken significantly.

Limited partnerships are generally formed with the primary objective of purchasing specific assets or a class of assets, 2/ and developing and operating those assets for a specified period of time. 3/ Most typically, the assets are to be sold and the proceeds to be distributed to the partners upon expiration of this period. Returns to the general partner in addition to management or other fees, both during the life of the partnership and upon its termination, often are subordinated in part to the interests of the limited partners in any proceeds. Any cash distributed to limited partners during the term of the partnership represents either income or a return on investment. Yield usually is measured on the basis of a present-value calculation of cash flow or total income benefits. Asset appreciation and deferral of taxable income are fundamental to overall yield in real estate. In the case of oil and gas, cash flow and the ability to shelter taxable income constitute the primary focus.

Commonly, the general partner makes little or no equity investment in the partnership. Instead, the general partner's contribution ordinarily takes the form of its

2/ Commonly in public partnership programs, interests in real estate or oil and gas partnerships are sold on a "blind-pool" basis, where the general partner specifies the type of property to be acquired by the partnership investment vehicle.

3/ Typically, the duration of a limited partnership is seven to 15 years, although the life of the partnership entity specified in the partnership agreement is generally considerably longer (35-50 years) than the intended period of operation. Where the life of the partnership and its intended period of operation are significantly different, the initial offering prospectus generally discloses that the actual term of the partnership is subject to certain factors (such as the market for the partnership's assets), and that adverse market conditions or other factors could delay liquidation of the partnership assets and final distributions to the limited partners. The prospectus advises that the disclosed term of operation may be changed by the general partner without the vote or consent of the limited partners. The general partner may not extend the life of the partnership unilaterally beyond the period allowed under the partnership's governing documents.

management of the enterprise. Although compensation arrangements may vary, 4/ they typically are based on fees for management services, property acquisitions or dispositions, and financing and refinancing transactions.

Limited partnership interests usually are not traded on a national securities exchange or the National Association of Securities Dealers Automated Quotation System ("NASDAQ"). 5/ The secondary markets for limited partnership interests generally are characterized by many small holders, extremely low trading volume and relative illiquidity. 6/ Few types of partnership securities are followed by financial analysts or investment banking firms. 7/ Approximately 15 small investment firms buy and sell partnership units, either for their own accounts or for resale to new investors. 8/

4/ Variations depend on a number of factors, including subordination of the general partner's interest in partnership profits to the interests of the limited partners.

5/ Most trading occurs in relatively isolated, individualized "accommodation" transactions handled privately by the broker-dealers that in most instances originally sold the selling investor his limited partnership interest.

6/ One source estimates that trading volume of publicly registered partnership units amounts to less than 0.5% of the interests outstanding. See Testimony of Cezar M. Froelich, Shelsky & Froelich Ltd., at 15, Oversight Hearing on the Reorganization of Limited Partnerships, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (Oct. 3, 1990).

7/ The staff has identified only three analysts evaluating partnership units on a regular basis, although some investment banking firms do provide research concerning partnerships they have sponsored.

8/ See Partnership Prices Slump for Quarter on 'Roll-Up' Fears, WSJ, Oct. 15, 1990, at p. C1, col. 6 (listing fifteen sources of quotations for partnership securities); Partnership Roll-Ups Can Cause Trouble, WSJ, Feb. 28, 1990, at p. A1, col. 5. See also Reselling Your Limited Partnership Unit, WSJ, Feb. 25, 1991, at p. C1, col. 2 (estimate of "perhaps 20 securities firms, mostly small," that buy and sell as principals). One of these secondary market participants, the Liquidity Fund, Inc.,
(continued...)

The significant illiquidity of the secondary market for limited partnership interests, as well as the risks inherent in the small asset base and the types of properties involved in a typical limited partnership, may make such partnerships a considerably more speculative investment for individual investors than more traditional securities or mutual funds.

Reflecting the speculative nature of these investments, the NASD has established its own regulatory framework to address the special concerns associated with the purchase and sale of limited partnership interests, which are termed direct participation programs ("DPPs") under the NASD's rules.^{2/} This regulatory regime is designed to ensure that only suitable investors are offered DPPs, and that those investors are fully informed of the attendant risks, including all pertinent facts relating to the liquidity and marketability of the program during the term of the investment.

All disclosure documents required to be filed with the Commission in connection with registered limited partnership offerings are reviewed by the Commission's staff. Those filings involving real estate or oil and gas offerings must include all the

8/(...continued)

has stated recently that it is the largest holder of real estate limited partnership units. See Congress is Probing New Partnership Deals, Wash. Post, Aug. 4, 1990, at p. E1.

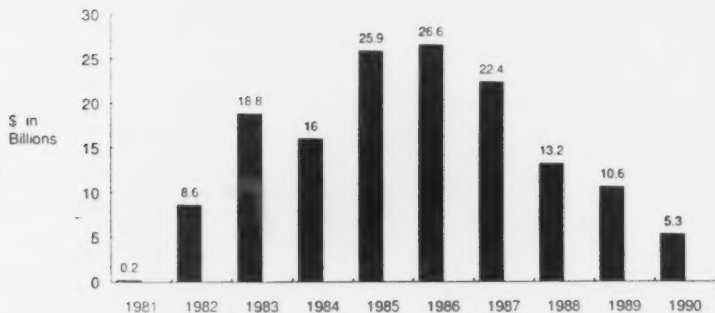
- 2/ See Appendix F to Article III, Section 34 of the Rules of Fair Practice, NASD Manual ¶ 2192 ("NASD Appendix F"). Note, however, that while Appendix F's heightened suitability requirements apply at the initial offering phase, they are not triggered in connection with a subsequent roll-up where the securities of the rolled-up entity are approved for trading on NASDAQ or a nationally recognized securities exchange. Accordingly, the NASD's general suitability requirements govern broker-dealer suitability determinations in a roll-up context. See Article III, Section 2 of the NASD's Rules of Fair Practice, NASD Manual ¶ 2151. All other provisions of Appendix F do apply to roll-ups.

information required by Industry Guides 5 and 4 respectively. Post-effective amendments specifying the properties acquired are also reviewed by the staff. A key focus of the review process is to highlight the risks inherent in a DPP investment, including lack of liquidity, the discretion and compensation of the general partners, and the restrictions on voting rights of the limited partners.

In the 1980's, more than \$148 billion of limited partnership interests were registered with the Commission. The majority were of interests in real estate or oil and gas partnership limited partnerships, although other types of partnerships became more common in the latter part of the decade. Moreover, as the following graph shows, total registered offerings declined in the latter part of the decade.

83

Registered Partnership Offerings



B. Description of Roll-Ups

In a roll-up transaction, a sponsor consolidates a number of public or private limited partnerships, real estate investment trusts ("REITs") or other investment vehicles into a single entity. This consolidation typically is accomplished through a merger of existing entities into the surviving entity, ^{10/} which is generally either a corporation or limited partnership. ^{11/} Investors in the predecessor entities receive an interest in the new entity, usually an equity security, but in some instances a debt security or some combination of debt, equity and cash. Whereas the securities of the predecessor entities for the most part are thinly traded in the secondary markets, the securities of the new entity often are listed on the New York Stock Exchange ("NYSE") or the American Stock Exchange ("AMEX") or traded on NASDAQ. ^{12/}

^{10/} Since January 1, 1985, 73% of the roll-ups for which registration or proxy statements have been filed with the Commission have been structured as a merger of existing partnership entities into the surviving entity. Exchange offers in which an entity offers to exchange its interests for the interests held by individual limited partners, and the limited partnerships continue to exist, account for 11% of the roll-ups filed with the Commission during this period. Another 16% of such roll-ups represents a combination of the foregoing whereby the proposal before the limited partners is a merger of the entities but, if the merger is not approved, individual limited partners may exchange their interests in the existing entity for one in the surviving entity.

^{11/} In roll-ups filed with the Commission since January 1, 1985, 57% of the new entities have been corporations, 33% have been limited partnerships, and 10% have been business trusts or corporations that will be taxed as REITs. Roll-ups of oil and gas partnerships typically use corporations; real estate roll-ups have used limited partnerships in 26% of the cases; corporations in 44% of the cases; and entities that will be taxed as REITs in 30% of the cases.

^{12/} Approximately 65% of the surviving entities are, or are intended to be, traded publicly -- 51% on AMEX, 29% on NYSE and 20% on NASDAQ.

Before sponsors may proceed with a roll-up, the requisite number of limited partners in each limited partnership, usually a majority of the outstanding limited partnership interests, must generally vote to approve the transaction. The actual vote required to approve the transaction is fixed by the terms of the limited partnership agreement in accordance with state partnership law. The Commission requires that applicable voting requirements must be disclosed in connection with the original prospectus for the limited partnership units.

Commission rules and regulations mandate that the disclosure documents used to solicit the vote or exchange of securities by the limited partners must be filed with the Commission for staff review and comment prior to their use to solicit investors. Because most roll-ups involve the solicitation of limited partners' proxy votes and the issuance of new securities, these documents usually take the form of a combined proxy statement, which is used to solicit proxies, and a registration statement, including a prospectus, which is used to register the new securities. ^{13/} The Commission's staff scrutinizes each roll-up filing carefully to ensure that all material information has been disclosed to investors. Following staff review and comment, and in many cases repeated revisions by registrants in response to requests from the staff for amended disclosure, the proxy statement/prospectus is disseminated to limited partners.

Once a particular roll-up transaction is approved by the necessary vote, all limited partners generally are bound thereby and will receive securities of the surviving entity in

^{13/} Although the structure of a particular roll-up will determine the specific Commission disclosure requirements that apply, these requirements are substantially similar. For purposes of this statement, therefore, it is unnecessary to distinguish among the various Commission rules that may apply.

exchange for their limited partnership interests. With respect to a roll-up structured as a pure exchange offer, however, as to which state partnership law ordinarily would not compel sponsors to solicit investor votes, a limited partner would not be bound by the actions of other limited partners unless the partnership agreement provides to the contrary. Where not all limited partners elect to tender their securities into such an exchange offer, the original limited partnership continues in existence, with the new entity as a major holder of the limited partnership interests.

In addition to combining the assets of multiple entities into a single entity, a roll-up may result in a number of other changes to the nature of the limited partner's investment. Limited partnerships generally are created to purchase and hold assets for a specific term of years culminating in the liquidation and distribution of proceeds to investors, while new entities formed in roll-ups often are intended to retain proceeds of asset sales for reinvestment over an indefinite period. Thus, a roll-up transaction may not only consolidate and diversify the original asset base, but also may convert the investment vehicle from a finite-life to a infinite-life entity.

A corollary of the change from finite to infinite life frequently is a change in the business plan of the entity. These changes may provide the general partner wider discretion in determining the types of assets to be acquired, as well as increasing the rights of the general partner to leverage the entity or to sell additional equity interests. Voting rights of the equity investors likewise may be altered substantially in the new entity. For example, the new entity may require a super-majority vote to replace the general partner, whereas the predecessor entity may have required a simple majority vote of the limited partnership interests for this purpose.

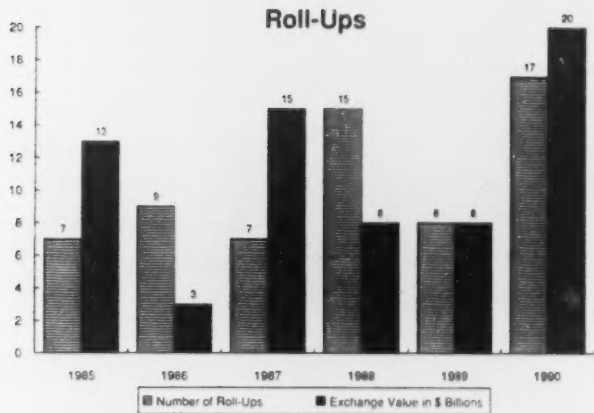
Compensation arrangements of the general partner also may differ significantly with respect to the new entity, often to the substantial benefit of that partner. The combined effect of substantially increasing the discretion of the general partner, converting to a broader business plan, and imposing a super-majority vote requirement to remove the general partner may substantially increase the risks of the investment. Of course, the Commission requires that all such changes and their implications for investors be disclosed fully in roll-up disclosure.

C. Trends in Roll-Up Activity

From January 1, 1985 to February 22, 1991, 65 roll-up transactions involving approximately 1200 entities have been registered with the Commission. ^{14/} Of these 65 transactions, 35 involved oil and gas partnerships, 19 involved real estate partnerships, and 11 involved other industries, including equipment leasing, medical services, computer software, cable television, research and development, cattle raising and feeding and motion-picture financing.

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^{14/} There are currently pending two real estate roll-ups, involving 19 entities with an exchange value of \$863 million, and one oil and gas roll-up involving seven entities with an exchange value of \$2 million. Seven additional roll-up registration statements have been withdrawn prior to becoming effective.



Roll-ups are often promoted as a market solution to deficiencies in the limited partnership structure that developed in light of changes in the regulatory and economic environments. As noted, tax legislation enacted in 1986 and 1987 significantly reduced tax benefits available over the life of the limited partnership vehicle that previously had attracted many investors. Moreover, the poor performance in recent years of the real estate and oil and gas industries in which most limited partnerships have invested has led to sharp declines in the value of partnership assets, investor returns and general partner revenue-based fees. Depressed economic conditions in a given industry likewise may diminish the ability of general partners to liquidate existing, finite-life partnerships on advantageous terms and to distribute the proceeds to investors in accordance with

original investment objectives. A roll-up in some instances may be pursued to avoid the commencement of bankruptcy proceedings against a partnership.

D. Claimed Benefits of Roll-up Transactions

Proponents of particular roll-ups generally point to a variety of potential benefits that could accrue to the limited partners. The most frequently claimed benefit to investors is the potential increased liquidity arising from exchange-listing or NASDAQ-quotation of the new securities issued in the roll-up. As noted above, most limited partnership interests prior to a roll-up are extremely illiquid. However, being listed on an exchange or quoted in NASDAQ provides no assurance as to the level of trading activity that might develop, or the price at which the securities eventually might trade. The Commission requires roll-up sponsors to disclose these potential limitations on liquidity.

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Another benefit often emphasized in soliciting documents is diversification of assets. Diversification can result either from varying the size or number of the assets held, owning a variety of assets (e.g., both residential and commercial real estate), or expanding the geographical areas in which the assets are located. There may be cases, however, where diversification would be disadvantageous for certain investors. To illustrate, a partnership that holds profitable properties may be rolled up with an entity holding less attractive properties. Alternatively, two partnerships each holding real estate in one economically depressed region may combine, with no benefit resulting from holding a greater number of similar properties in the same troubled area. In order for limited partners to assess properly the value of the proffered diversification, the Commission requires extensive disclosure concerning the assets of each entity to be

rolled up. The Commission also requires that all material aspects of the risk of such transactions must be discussed, including the possibility that cash flow from more viable partnerships could be diverted to finance operations of poorly performing partnerships.

A third often-suggested potential benefit is more streamlined, cost-effective management. Many roll-up sponsors have argued that consolidation of multiple management would reduce management, administrative and operating activities and costs. Potential savings here usually are not described as substantial, and often they are not quantified. If the general partner is unable to quantify these benefits, the Commission requires that the prospectus disclose that the amount of such savings is not known or readily quantifiable. Where administrative cost savings are claimed to represent a major benefit, Commission requirements call for quantification in the prospectus of the magnitude of the anticipated savings. Such information provides an investor a basis to evaluate the likelihood of the cost savings to the surviving entity and to compare these savings with the expenses to be incurred in the transaction.

Growth potential is also often cited as a reason for pursuing a roll-up. Because the change from a finite to an infinite-life vehicle allows partnership management to defer or even to forego distribution of income or cash flow to investors, and thus to reinvest proceeds from sales and refinancings, the roll-up sponsor may indicate that the survivor will have a greater potential for growth than the predecessor entities. Also, the organizational documents for the existing limited partnerships may contain operating or investment restrictions that would not apply to the survivor. Accordingly, the survivor would have a wider range of opportunities for investment. Of course, flexibility may not

result in growth that causes appreciation in the value of the investors' securities, and it may expand the previously disclosed risks of the enterprise.

Finally, roll-ups often are promoted as affording greater flexibility in the capital structure of the survivor. Given the surviving entity's ability to avoid liquidation and distribution indefinitely, and its larger investor and earnings base, that entity is expected to have access to a broader range of capital sources on more favorable terms. Greater flexibility may be particularly important where the partnerships are not able to liquidate within the time periods originally anticipated due to depressed economic conditions. By the same token, the risk that increased debt or new equity may redound to the detriment of the original equity holders must be disclosed clearly in the requisite Commission filings.

Whether projected benefits would be realized through a particular transaction, and whether the costs of achieving those benefits ultimately would be justified, would depend on the facts and circumstances of each roll-up. They would also depend on the individual interests of the investors in the various programs. To the degree that significant new fees are charged to the rolled-up entities, the initial direct result of a roll-up will almost always be negative for the affected partnership interests. Possible future savings and the benefit of any greater liquidity must offset the fees and any new or higher compensation to general partners and others before any such transaction could be beneficial to investors in the prior entities. Of course, investors in some of the rolled-up entities could suffer disproportionately more losses than investors in other entities.

III. Concerns Raised With Respect to Roll-up Transactions

A. Conflicts of Interest

Roll-ups are frequently devised and promoted by the general partners of several or all of the limited partnerships to be rolled up. The general partners often obtain both a substantial equity interest in the new entity and serve as its management. Thus, the multiple roles of general partners in roll-ups create multiple potential conflicts of interest.

First, there is the question of the allocation to the limited partners of equity in the new entity, which is commonly affiliated with the general partner of the partnerships to be rolled-up. The general partners often have both a pecuniary interest in receiving a substantial equity share in the roll-up entity and fiduciary duties to provide fair shares to their limited partners. Indeed, they may have conflicting fiduciary duties to other partners or to existing holders of securities of the new entity. Second, there is the related question of the allocation of equity among the various limited partnerships, for there may be a temptation to favor the limited partnerships in which the general partners have substantial equity interests. Third, and perhaps most important, there is the question of compensation for the general partners after the roll-up. Limited partners often believe that the complex salary, management fee, acquisition fee and cost reimbursement arrangements proposed in roll-ups favor the general partners at the expense of the limited partners.

These potential conflicts are not unlike those often present in transactions between a corporation and its managers, or in transactions between two corporations under common control. As in the case of corporate law, state partnership law does not

prohibit all transactions between general partners and the partnership, or between affiliated partnerships, since such transactions may in fact benefit all parties. Instead, state partnership law allows such transactions, subject to specific proscriptions in the partnership agreement and to the limits imposed upon the general partners by their fiduciary duties. The remedies of class action litigation or individual lawsuit are available, of course, to enforce these state law rights of the limited partners and duties of the general partners.

Similarly, the federal securities laws do not impose substantive limits on transactions between affiliates that require shareholder votes or involve the issuance of new securities. Rather, the federal securities laws and the Commission require full disclosure of all material facts regarding such transactions, so that investors may make informed judgments about the proposed transaction.

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With respect to roll-up transactions in particular, the Commission requires extensive disclosure of any material differences in the relative rights and economic interests of the general partner and the limited partners, both prior to and after the roll-up. Roll-up proxy statements thus must disclose whether, after the roll-up, the issuer will pay affiliates to manage or service its properties, purchase properties from or sell properties to affiliates, purchase properties jointly with affiliates, or engage in other affiliated transactions. Disclosure must be made that the new entity may be in competition with affiliates or control persons operating in the same industry, whether for specific properties or other business opportunities or services, since it is possible that these affiliations or control relationships could influence the judgment of the new entity's

managing personnel in determining whether to pursue, accept or reject business opportunities.

Moreover, the Commission requires that roll-up sponsors provide investors detailed information about fees and other financial arrangements or allocations to the general partners, both before and after the roll-up. The Commission further requires disclosure of any beneficial change in the previously contingent character of the general partner's interest in the proceeds of the predecessor partnership, including elimination of heretofore subordinated claims to partnership profits. ^{15/}

Some have suggested that the potential for conflict inherent in the relationship between general and limited partners is so great that it requires the mandatory establishment of an independent board of trustees, counsel and financial advisers to represent the interests of the limited partners. Such independent advisers are not common in roll-up transactions. To the extent the limited partners believe that the general partner is in breach of its fiduciary duties, they may sue to enjoin the roll-up or seek damages under state partnership law.

B. Change from a Finite-Life to an Infinite-Life Investment Vehicle

Most limited partnerships are organized as finite-life investment vehicles with the goal of liquidation and distribution of proceeds to investors within a prescribed period

^{15/} See Testimony of Richard G. Wollack, Chairman, Liquidity Fund, Inc., at 10, Oversight Hearing on the Reorganization of Limited Partnerships, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (Oct. 3, 1990) (most general partners emerge from the roll-up with a larger stake in the surviving entity than in any of its predecessors because they convert their original general partner interest, which generally has been subordinated to those of the limited partners, into immediate cash or a guaranteed right to proceeds of future asset sales and refinancings).

after inception. By contrast, most rolled-up entities are organized as infinite-life entities. Critics of roll-ups charge that such a change in the duration of the partnership investment vehicle represents so profound an alteration of the original partnership structure that it should not be imposed on any individual investor without his or her consent.

Roll-up disclosure documents prescribed by the Commission focus on the significance of the shift from a finite-life to an infinite-life entity. Whether or not partnership assets should be retained indefinitely in a new entity, or eventually sold and the proceeds distributed pursuant to the original investment objective, is one of the most critical issues to be weighed by investors asked to participate in a proposed roll-up.

Thus, the Commission requires that all material effects on investors of a change from a finite- to infinite-life investment vehicle be described both clearly and prominently in roll-up filings.

Under state partnership law, a limited partner is viewed as an equity investor, whose rights under the partnership agreement may be substantially restructured. This may be accomplished either through amendment of the partnership agreement, or through a merger over the investor's objection, if the approval required by the partnership agreement is obtained, usually by an affirmative vote of at least a majority of investors. A similar result would obtain in the context of a corporate merger, where a shareholder who opposes a reorganization nonetheless will be forced to participate in the event of a majority (or greater) shareholder vote authorizing its consummation. To enable prospective investors to determine on a fully informed basis whether to assume this risk at the time of the initial partnership offering, the Commission requires that the

rights of limited partners under the partnership agreement and the potential for those rights to be modified or restricted by a vote of some prescribed percentage of the limited partners must be disclosed prominently in the offering prospectus.

Some have suggested that a finite-life option be required in all roll-ups; others have proposed that dissenting limited partners be given the right to opt out of a roll-up and to retain their original investment. Extension of dissenters' or appraisal rights, similar to those now available almost exclusively in the corporate context, to limited partners who wish to receive the fair value of their investment rather than an interest in the surviving entity, has also been recommended. ^{16/}

Mandating that limited partners be given the option of choosing between a finite-life and an infinite-life vehicle would be very difficult. If a finite-life option were made available, the length of the term would become an issue because roll-ups of multiple limited partnerships involve entities with varying periods remaining in their intended terms. Even a finite-life vehicle probably would extend the investment period of some limited partners well beyond that contemplated at the time of their initial investment.

C. Imposition of Super-Majority Vote Requirements

A controversial aspect of roll-ups is the increase, as part of some roll-ups, of the vote necessary to remove the general partner from a simple majority to a super-majority.

^{16/} At the state level, four jurisdictions provide appraisal rights to limited partners in connection with a merger or other reorganization -- California, Maryland, the District of Columbia and New York. See Cal. Corp. Code §§ 15679.1 to 15679.13 (eff. Jan. 1, 1991) (added by 1990 Cal. Stats. ch. 1088); D.C. Code Ann. §§ 41-428(e),(h) (Supp. 1989); Md. Corps. & Ass'n Code Ann. § 10-208(f) (Supp. 1988); 1990 N.Y. Laws Chapters 950-952 (eff. April, July 1991) (to be codified at N.Y.P.L. art. 8A §§ 121-101 *et seq.*). Like many state corporate statutes (see, e.g., Del. Code Ann. Tit. 6 § 262(b)), partnership statutes may restrict appraisal rights of limited partners. See e.g., Cal. Corp. Code § 15679.2.

Voting requirements necessary to effect partnership action, including removal of the general partner, are governed by state partnership law. Typically, partnership law provides for partnership action based on the vote of a majority of limited partnership interests, except as may otherwise be provided in the partnership agreement. Most limited partnership agreements provide that the general partner can be removed upon the vote of 51% of the outstanding limited partnership interests.

Speaking personally, I am deeply concerned about any action taken by a state, stock exchange, corporation or partnership to disenfranchise investors. Investor voting is critical both to the continued accountability of management of particular enterprises, as well as to the general attractiveness of long-term equity investments in this country. I would certainly favor steps that would make it more difficult for the general partners of limited partnerships with substantial numbers of limited partners to insulate themselves through super-majority voting requirements, whether as part of a roll-up or in any other way. Roll-up documents filed with the Commission are required to highlight any vote change that would result from the transaction and its implications for investors. There is some evidence that this is a key factor in limited partners' analysis of the merits of these transactions.

D. Post-Roll-up Price Performance

Critics of roll-ups also argue that, after a roll-up, the price of the new security generally declines. To reach this conclusion, however, some of these critics have compared the exchange values (appraised values) used in the roll-up with the market prices after the roll-up. Exchange values are used principally for the purpose of allocating equity interests among the limited partnerships involved in a roll-up. As such,

exchange values are neither estimates of liquidation value nor estimates of market prices after the roll-up. Indeed, the Commission requires that roll-up documents disclose that exchange values are not estimates of market value, and that market prices after a roll-up will generally be substantially lower than exchange values. Thus, a comparison of exchange values and market values is not particularly useful.

The Commission's Office of Economic Analysis is examining the available data on post-roll-up price performance of securities issued in roll-up transactions. Preliminary figures, based on a limited group of securities, indicate a decline, on average, adjusted for trends in the industries involved, in the trading price of these securities of 25% in the first year.

In view of the apparently poor price performance of roll-up securities, some have suggested that there is a need for disclosure in roll-up materials of (1) the proceeds the limited partners and general partners would receive, respectively, if the properties were liquidated at appraised value under the terms of the limited partnership ("liquidation value"); (2) the net value to be received (after fees and other expenses and assuming sale of assets after the roll-up) by the limited partners and the general partners according to the forecasts contained in the disclosure materials if the roll-up were to be approved; and (3) the projected trading value of the roll-up instrument. The Commission's staff is reviewing valuation information currently being provided to investors to determine whether existing disclosure requirements should be revised or further guidance given to registrants. A particular focus of the staff review is on whether liquidation or dissolution value should be discussed in the disclosure document.

Comparisons to trading value appear problematic. Specific projections as to the trading value of the roll-up instrument generally are not included in the disclosure documents, given their speculative nature. Roll-up documents must disclose prominently, however, that the new instrument likely will trade substantially below the exchange value initially assigned by the issuer. In addition, the staff is reviewing the utility of pro forma cash flow information which some analysts use in assessing potential trading value levels of some types of securities.

E. "Fairness" Opinions

Roll-up sponsors in many instances obtain an opinion from an investment banking firm or other financial adviser that the consideration to be received is fair, from a financial point of view, to the limited partners. There have been some complaints that authors of such "fairness" opinions are not independent of roll-up sponsors, since these advisers often are paid at least in part on a contingent fee basis. Therefore, they often have a significant financial interest in the outcome of the transaction. Neither state partnership law nor federal securities law requires that a fairness opinion be obtained. Fiduciaries frequently seek a fairness opinion to help demonstrate that they have met their fiduciary duties in approving a merger or other acquisition in the event of investor challenge. The degree of independence of the adviser providing the opinion is taken into account both by the courts in assessing the fiduciary's exercise of due care, and by security holders in evaluating the opinion's reliability.

The Commission requires that disclosure be made in roll-up filings of all relevant information bearing on the independence of the adviser, including the terms of the current engagement, the nature of any contingent fee arrangement, or any past or

anticipated future relationship between the sponsor and the author of the fairness opinion. Such disclosure must state explicitly whether independent testing or analysis has been performed. If a financial adviser's opinion, report or appraisal is referred to in the disclosure documents, the Commission requires that the opinion, report or appraisal be summarized. Although it is not generally mandatory, roll-up sponsors usually provide the adviser's opinion to investors.

F. Broker-Dealer Solicitations of "Yes" Votes

Approval by a majority vote of limited partners is necessary to effect most roll-ups, often requiring sponsors to solicit proxies from investors. Registered representatives of the dealer-manager that generally serves as financial adviser to roll-up sponsors and other broker-dealers are often paid a commission by sponsors for soliciting and delivering proxies favoring a roll-up, but receive no payment for delivery of a negative proxy vote. Critics argue that this practice creates undue incentives for broker-dealers to encourage investors to approve a roll-up other than on its merits.

The degree to which limited partners rely upon the recommendation of a registered representative will vary greatly, depending upon a number of factors, including the complexity of the transaction, the sophistication of the investor, and the relationship between the investor and the registered representative. A broker-dealer's failure to disclose certain information, which could include the receipt of special compensation, in some circumstances would constitute a violation of the general antifraud provisions of the federal securities laws. For example, particularly where there is a relationship of special trust and confidence between the broker-dealer and the customer, the broker-dealer may have a heightened obligation to disclose key facts, such as its compensation

arrangement with a roll-up sponsor. There is a specific requirement under the federal proxy rules that a dealer-manager or soliciting dealer engaged in the solicitation of proxies in conjunction with a roll-up transaction disclose the compensation it expects to receive for these activities.

Of those roll-ups filed with the Commission since January 1, 1985, approximately 52% have involved an incentive-fee arrangement with soliciting dealers. For a dealer to receive this fee, an investor must approve the transaction and insert the name of the soliciting dealer in the appropriate space provided on the consent form. In such transactions, the fees paid to soliciting dealers have been based on the number of affirmative consents obtained, rather than the total number of votes cast. Fees have ranged from two to three percent of the exchange value with respect to such consents. ^{17/}

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In the other 48% where an incentive fee was not paid as part of the solicitation process, generally the sponsor or an affiliate conducted the solicitation. Sponsors often undertake a solicitation when the number of limited partners is few or the limited partners are centrally located. When an incentive fee is not being paid as part of the solicitation, the soliciting documents generally indicate that the broker-dealers will be reimbursed for any reasonable expenses incurred as a result of the transaction.

^{17/} Based on those roll-ups filed with the Commission since January 1, 1985, in which an incentive fee was paid, the incentive fee was between 2% and 2.5% in 74% of those roll-ups; between 4% and 5% of the exchange value in five roll-ups and between .5% and 1.8% in five roll-ups. The average incentive fee was 2.2% of exchange value. Therefore, the aggregate incentive fees paid on all such transactions could range as high as \$136,415,000.

The practice of compensating broker-dealers only if a proxy vote in favor of a roll-up is procured may create a conflict between the broker's pecuniary interest and his fiduciary duty to make suitable recommendations to customers. ^{18/} The NASD has proposed for comment to its membership a rule to proscribe such practice. ^{19/}

IV. Remedies Available to Roll-Up Investors

Limited partners opposed to a proposed roll-up or seeking recourse for a completed roll-up have several remedies. Limited partnership agreements, in accordance with state law, generally allow limited partners to vote against the proposed roll-up. If enough limited partners vote against it there will be no roll-up. Critics of roll-ups sometimes lose sight of the fact that general partners ordinarily cannot force a roll-up upon limited partners without obtaining a majority vote in favor of the transaction. In two recent roll-ups, approximately thirteen partnerships voted against the transaction and did not participate in the roll-up.

A limited partner may also challenge the substantive fairness of a transaction by suing the general partner on state-law theories of breach of contract (based on specific terms of the partnership agreement) or breach of fiduciary duty, or by suing both the general partner and the issuer for fraud. Such actions would be predicated on the terms of the roll-up and the general partner's role in negotiating or accepting those terms.

An investor or class of investors also may sue under the state and federal securities laws if the disclosure required by such laws was not provided or was false or

^{18/} See Article III, Section 2 of the NASD's Rules of Fair Practice, NASD Manual § 2151.

^{19/} See NASD Notice to Members 90-79 (Dec. 1990).

misleading. Antifraud claims arising out of material misrepresentations or omissions in Commission disclosure documents may be brought by investors under Sections 10(b) and 14(a) of the Securities Exchange Act of 1934 and Rules 10b-5 and 14a-9 thereunder, 20/ and Sections 11(a) and 12(2) of the Securities Act of 1933.

Investors may bring suit to enjoin a roll-up prior to its consummation on the basis of breach of the general partner's fiduciary duties or violation of antifraud provisions. After the roll-up, investors may seek rescission of the transaction, or damages in the amount of the financial harm suffered under federal and state law. Since roll-up transactions generally are registered under the Securities Act, a limited partner who believes the prospectus used in connection with the roll-up was materially false or misleading could seek damages under Sections 11(a) and 12(2) of the Securities Act. A damages remedy likewise would be available under the Exchange Act for violations of Section 10(b) and Rule 10b-5, as well as Section 14(a) and Rule 14a-9.

A number of limited partners, either prior to or after completion of a roll-up, have filed suit in federal or state court challenging the roll-up. These lawsuits typically are class actions. It appears that almost all of these suits to date have been settled out of court. Since few results of this litigation have been reported, no conclusion can be

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20/ If the transaction is structured as an exchange offer covered by the Williams Act amendments to the Exchange Act, suit also may be brought on the basis of material misrepresentations or omissions in the tender offer documents. If the roll-up transaction has a "going-private" effect within the meaning of Rule 13e-3, an investor also may sue under Section 13(e) of the Exchange Act and Rule 13e-3(b)(1) thereunder for fraudulent disclosure in the Commission's Schedule 13E-3 filed in connection with going-private transactions.

reached regarding the nature of the remedy, ^{21/} the amount of any damages that investors may have recovered or how such amounts might compare to any damages actually suffered as a result of the roll-up.

To date, the Commission has not brought any enforcement actions arising out of a roll-up. The Commission has investigated and is investigating several such transactions, but pursuant to its standard investigative policies, cannot disclose the identity of the transactions and parties under investigation. In addition, the Commission has filed a number of enforcement cases recently alleging fraud in the offer and sale of limited partnership interests. ^{22/} In early 1990, the Commission instituted and settled administrative proceedings under Section 8(d) of the Securities Act, suspending the effectiveness of a limited partnership's registration statement that

^{21/} In one of the few reported decisions in this area, a federal district court enjoined the transaction pending corrective disclosure by both the third-party bidder and target partnerships in connection with a roll-up proposed to be effected pursuant to a hostile exchange offer. See American Insured Mortgage Investors v. CRI, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,730 (S.D.N.Y. Nov. 26, 1990).

^{22/} See SEC v. William A. Bates and Orville O. Bierbaum, Litigation Release No. 12673 (October 18, 1990); SEC v. Maxwell C. Huffman, Jr., Litigation Release No. 12618 (September 10, 1990); In the Matter of Mysore S. Sundara and Mysore S. Sundara & Assoc., Inc., Exchange Act Release No. 28419 (September 10, 1990); In the Matter of Michael C. Beatty, Exchange Act Release No. 28356 (August 20, 1990); SEC v. John J. Marston d/b/a/ Marston and Associates, et al., Litigation Release No. 12491 (May 29, 1990); SEC v. Joseph B. Edington, et al., Litigation Release No. 12588 (August 17, 1990). Several of the Commission's actions during 1990 involved allegations of fraud in the offer and sale of oil and gas limited partnerships (see SEC v. Profit Enterprises, Inc., et al., Litigation Release No. 12588 (August 17, 1990); SEC v. Alan O. Melchior, et al., Litigation Release No. 12571 (August 8, 1990); SEC v. Transwestern Oil & Gas Co., Inc., Litigation Release no. 12518 (June 20, 1990)), or interests in real estate limited partnerships (see SEC v. Reddington Investments, Inc., Litigation Release No. 12613 (September 10, 1990)).

allegedly contained misrepresentations and omissions of material fact. ^{23/} The Commission has prosecuted defendants for alleged misappropriation of funds from limited partnerships. ^{24/} Commission actions also have included proceedings for fraud in connection with limited partnership offerings brought against such regulated persons as registered representatives associated with broker-dealers, ^{25/} or individuals associated with investment advisers. ^{26/}

V. Adequacy of Present Commission Regulation

For over fifty years, the guiding principle of the federal securities laws has been full and fair disclosure to the investing public of material information, leaving to the investor the final decision of whether or not to buy, sell or exchange a security. Rather than examine the merits of, and either approve or disapprove, a proposed roll-up transaction, the Commission's role is thus to ensure that complete, detailed and understandable disclosure is provided to investors to enable them to make their own informed decisions about whether to participate in a proposed roll-up. Commission rules and regulations are designed to make certain that investors receive all material information bearing on the merits of roll-up transactions, including the economic and

^{23/} In the Matter of Telco Payphone Limited Partnership II, Securities Act Release No. 6855 (March 2, 1990).

^{24/} See SEC v. Jeffrey L. Gee, et al., Litigation Release No. 12634 (September 26, 1990); SEC v. Steven G. Osguthorpe, Litigation Release No. 12495 (June 1, 1990).

^{25/} See SEC v. Arthur Jackson Curry, Litigation Release No. 12689 (November 1, 1990).

^{26/} See In the Matter of Edward G. Kanavel, Jr., Investment Advisers Release No. 1221 (February 5, 1990); In the Matter of H. Van Eerden, Investment Adviser Release No. 1239 (July 5, 1990).

Senator DODD. Well, as usual you preempt a lot of the questions in your testimony, and I appreciate it.

I cannot really argue with a lot of the things you are suggesting or recommending.

I am going to put up that—can I ask someone over here to put that chart back up that Mr. Wollack had up, the one that shows the likely increase in rollups? Yes, that is it.

That is the pace of rollups.

I cannot vouch—and I am not suggesting that Mr. Wollack is not being accurate, but I would not want to suggest to you that I know this to be absolutely accurate, but I suspect it is pretty close.

They are talking about 500,000 investors to be rolled up by 1991.

To give you a flavor, and I cannot really read the numbers from here even with these glasses on, but you see through the 1980's, and it is even a 50-percent increase over what occurred in 1990, so there seems to be an accelerating pace here.

While I agree with you that the numbers you are talking about in terms of I think you said \$450 billion on the corporate side and \$6.9, we are still talking about roughly 8 million investors out here, which is pretty significant in its number.

And again, it is the ripple effect.

It is the notion out here of what the climate is like for the small investor in the general range of securities and so forth, and what the impacts of that are.

I think that really is where it becomes important, as opposed to a comparison of numbers, if you will, in that particular sense.

I find that pretty alarming, because if in fact word is going out that you are getting these, all of a sudden it is not unlike the equity loan.

I was thinking of that as you were talking about it in terms of the changing conditions.

I mean, there was the equity loan in which we attracted the mortgagee to come into the process to borrow more money. Then, up until a few years ago, you could change the arrangements in which you could call that loan prematurely, or do a variety of other things which the borrower was not agreeing to when they went into the arrangement, or at least as to what they thought they were getting into.

There have been a number.

And I suggest, and would hope it would be the case, that what we are talking about here is that, to the extent we need to make some changes—and I believe we do—that it could be done primarily through a regulatory process and does not require legislation.

Or do you, Mr. Chairman, see some need here for some legislative action, as well, potentially?

Chairman BREEDEN. First, Mr. Chairman, let me agree with you totally that in citing the relative comparison between the value of rollups and the value of tender offers, I was not suggesting to you in the slightest that this is not a terribly important subject.

As far as I am concerned, if even one investor gets cheated or abused and is deterred from participating in the securities' markets, that is one too many for me.

So I certainly agree with you on that score.

I cannot comment on the projections.

Under our rules, we do not make projections out into the future, so I cannot speak for the expectation regarding rollups in 1991.

There are two charts in my testimony, one on page 9 and one on page 14, that may be at least partially reflective of some of what is going on.

Page 9 shows the volume of registered partnership offerings by year.

As you can see very clearly, following the tax reforms in 1986 the volume of new partnership offerings is absolutely plummeting.

Senator DODD. Yes.

Chairman BREEDEN. So as the sponsors and promoters have found it very difficult to sell new partnerships to investors out there.

What you see on page 14 is a relative increase, and it is consistent to some degree with the chart you have put up there, you see a relative increase in the volume of rollup transactions.

So that we have seen in a sense a shift from pumping out new limited partnerships to rearranging the deck chairs of the partnerships that already exist.

Now we can and will, as I tried to indicate in my testimony, we will use the authority we have under the Federal securities laws to require full and good disclosure.

I think there are some areas where that disclosure has not been good enough.

The information is there, but if it is in the middle of an 800-page document, it might not be very effectively available.

THREE AREAS CRUCIAL TO CORPORATE GOVERNANCE

But the three areas that really are crucial to the corporate governance and really to the protection of investors across the board are:

(1) You need to be informed. You have to have enough information to start with.

(2) You have to have the right to do something with that information, principally in the voting areas; and, if you have got a rascal running a company or a partnership, to vote them out and replace them with someone who is not going to abuse the participants.

(3) You have to have a stick, and the stick generally is the right to bring lawsuits for abuse of duties owed to the nonmanaging, the passive investors whether they were shareholders or limited partners.

Now we have the ability, Congress has given us the ability, to make sure that the first leg of the stool, the first of those three attributes, is always protected; that the disclosure is there and the information is out there.

The ability to vote and the ability to sue for fiduciary duties, and the scope of those duties are matters that are within the traditional competence of the States. They are matters of State law.

I would say that it would be very difficult, absent legislation, for the Commission to do anything in those two areas.

We cannot, regrettably—I wish we could do more to insist on shareholder voting rights than we have been successful so far in achieving.

Senator DODD. Well, maybe we ought to look at that.

Senator HEINZ. Mr. Chairman, may I just make a clarification?

Richard, at the beginning of that before you listed those items, did you say there were three on four items?

You listed three.

Are there just three?

Senator DODD. I think he said three.

Chairman BREEDEN. I think three.

Senator HEINZ. Three? Fine.

Then I misheard.

Chairman BREEDEN. But if I come up with a fourth, I will toss it back in. [Laughter.]

Senator DODD. Well, we might want to consider that because it is—now granted, the numbers are coming down.

I suspect you are going to see some changes in the tax laws on real estate, and I certainly think there should be, quite frankly.

One of the problems I have seen economically is the tax-activating six I think did a great disservice in these areas.

I am not asking you to comment on that, but I would just make that personal observation.

I suspect that at some point you are going to see some changes here.

So you may see that dollar volume begin to move up again—I hope it is the case, anyway.

If it does, then I think the consideration of some legislation in this area so that you do not end up in this sort of never-never land where you are beyond the reach of States, and yet it really is not in your jurisdiction either.

You have got people out there functioning with an almost *de jure* *ende facto* where they can operate virtually free of the kind of scrutiny that is necessary.

So I think we may want to take a look at that. Obviously you get into a very sensitive area when you start talking about the Federal Government encroaching upon States' rights in those areas, but nonetheless if it is not being done out there and you have got the volume of people that are being adversely affected, I think it may make some sense and it may have less opposition than usual.

You mentioned three, and in fact I wrote down the three—protecting of dissenters' rights, and the procedural and structural safeguards and the information flow.

I should probably have it in the other order, but nevertheless Mr. Wollack made similar recommendations in his own testimony.

DISCLOSURE PERIOD

The information flow, again information so vitally important, it appears as though a lot of these decisions to move into the rollup area occurs months before the limited partners find out about it.

In some case, they are given 20 or 30 days to respond to the prospectus.

I presume you are talking here about getting that information earlier to these people, and not only more clearly but getting it to them earlier as well so there is some idea of what has happened?

Chairman BREEDEN. Well, we would not want information to be put out before there was a definitive transaction.

If it is in the thinking and talking stage, I was not suggesting putting out a lot of prospectuses or proxies on possible transactions. But one of the things I indicated, we are certainly looking at whether or not there should not be an understanding of something like we have in the Williams Act with a notion of once the document does go out that there has to be some minimum period of time before it is going to be acted upon so that you do not have an undue compression of the time required to think about the transaction. Now in actual practice we have seen minimum solicitation periods ranging from about 30 days, which is generally consistent with what we have in the Williams Act, out to 120 to 130 days and, in one transaction, 171 days. So we have not seen, that I am aware of, any transactions where people had 3 days in which to vote.

But we are going to look at the question of whether there needs to be some more formal understanding of a minimum disclosure period.

DISSENTERS' RIGHTS

Senator DODD. But you comment again on the dissenters' rights issue. We touched on that briefly but just the notion of what sort of dissenters' rights should there be and to what extent do you have the ability to make a difference in that?

Chairman BREEDEN. Well, the greatest protection of dissenters' rights is very difficult to separate from the broader question of dissenters' rights. You have to start with the question of do you get to vote on a transaction at all and what are the standards for what it takes to approve the transaction or not approve it, as in the case of the—because, in the corporate area, you have to traditionally, among other prerequisites before you can claim dissenters' rights is you have to have voted against the transaction. If you voted for it, obviously, you can't turn around, in most States, you can't turn around and claim appraisal rights.

Under the Delaware partnership section I read to you, there are many transactions in which the limited partners don't get to vote at all unless the partnership agreement otherwise provides. So the first step is, I think, an essential step to clarify the degree to which people have a right to vote. And then you can say what happens, what are the consequences if a vote is taken to compel against their will investors to engage in certain transactions. And where they voted no, you know, if there wasn't a certain percentage of yes votes, then that there would be some form of dissenters' or appraisal rights subject to specific statutory exceptions.

But I really don't think you can separate voting rights from appraisal rights. To do one you probably need to look at doing both of them. Traditionally, that is purely a matter of State law, has not been a matter of Federal law. And I don't think that under existing law there is a great deal the Commission could do to compel

appraisal rights. The State law either provides them or doesn't provide them.

Senator HEINZ. Can I jump in, Mr. Chairman? Really, I want to get back to the issue Senator Dodd was honing in on, which is disclosure, one of those three areas.

The testimony we had from Mr. Wollack at page 5 suggested that, with 800 pages, to quote him, full of legalese and technical jargon, that there may be such a thing as too much disclosure. And, second, in terms of quality of disclosure, that it's pretty difficult to find in those 800 pages that which is even under those circumstances meaningful and relevant.

That's the SEC's bailiwick. What should you be doing about that?

Chairman BREEDEN. Well, as I indicated, I have a great deal of sympathy with that criticism. I think some of the documents—before this hearing I did ask to see some of the filings that had been made and some of them are about this thick. And you can, if you throw every fact in the world into the document, make it hard to find the two or three sentences that might be critical if they're buried on page 423.

Senator HEINZ. And what—what should the SEC consider doing about that?

Chairman BREEDEN. Well, I will not concede, for those sponsors that might be listening out there, that an attempt to bury significant information in the middle of a document constitutes compliance with the disclosure requirements. And we will look at cases where we find failure to adequately set forth the significant items.

The Commission's rules require that prospectuses, and I note parenthetically that many corporate offering documents can be quite thick also, summarize the most significant factors up front in the first few pages. This approach is required with respect to roll-up prospectuses, and where it isn't complied with, we should bring a few actions.

Senator HEINZ. I assume that there is precedent for the SEC finding that information has not been appropriately provided? That is to say, even though it's in there, it has been buried and has been surrounded by other facts that result in its either being discounted or misconstrued?

Has the SEC ever taken enforcement action based on such a situation?

Chairman BREEDEN. I am very reliably informed that, yes, we have brought some actions in that area where—

Senator HEINZ. Have you ever fined anybody?

Chairman BREEDEN. I don't believe we would have fined them since we didn't obtain that power until last October and prospectively only, so I don't think we've—I know we haven't used that authority.

INJECTIVE RELIEF

Senator HEINZ. Have you sanctioned anybody in any way for ever doing this?

Chairman BREEDEN. I would be very happy to furnish to you some information on that. I would say we almost certainly have

gotten injunctive relief against people who put out disclosure documents where the disclosure was so obtuse that you couldn't find it.

Senator HEINZ. Do you know if the injunctive relief that you got has been timely? I mean, has it been within the 30- or 60- or 90-day period?

Chairman BREEDEN. It is inconceivable to me that it would have been.

Senator HEINZ. That it would have been timely?

Chairman BREEDEN. It is virtually certain it would not have been timely. This is injunctive relief that says, you violated the law; don't do it a second time. It does not help—now we do have—

I want to say the only remedy is not enforcement action, and that does come later, says don't do it again, or at least until Congress gave us the authority to impose a fine. And we hope to change that syndrome.

We also have provisions in the basic—

Senator DODD. Richard, excuse me. Let me just—hold it right there.

As I understand it, were you to sanction an entity, you would sanction a partnership as opposed to the individual general partners specifically?

Chairman BREEDEN. Depending on the relationship between the general partner and the degree of culpability in causing a violation of the laws to occur, I wouldn't want to concede that we would not bring an action directly against a promoter or a general partner.

Senator HEINZ. Obviously the concern is that every partnership has a different name. You sanction a partnership.

Chairman BREEDEN. Right.

Senator HEINZ. You say, don't do it again. Well, there will never be a partnership with the same name and, indeed, the combination of partners, will never be the same. So I'm not quite sure what—even if you were doing everything perfectly and had been doing so for 20 years, I'm not sure what not doing it again would mean.

Chairman BREEDEN. There are very real limitations to the utility of injunctive relief. There are certain types of areas where it isn't good enough sanction. And that is why we came to Congress for the monetary fining authority.

But there are areas—this arises in the corporate area as well, where you may have a corporation that is charged with an injunctive action and sometimes the individual officers and directors are also named individually, and the same would be true with partnerships.

I did just want to correct the record on one point, which is that in the requirements for offering documents where we require a summary up front of the pertinent risk factors, we of course could refuse to accelerate the effectiveness of registration statement where they failed to comply with the format requirements of the document, so there is an ability to influence the process at the front end of saying that registration statement can't go effective until it has a summary that's readable. There's also a process at the back end that comes along later and says, wait a minute, you pulled this transaction on people and you didn't adequately disclose it in bringing an enforcement action.

Senator HEINZ. There is a case history involving the McNeal Real Estate Fund Eight that was distributed to members of the subcommittee as part of the briefing material for this. I understand it's a real case history. I don't know if it's been provided to you.

If you do not have it, don't worry about it; we'll provide it to you.

I think the problem that's illustrated in it is a common problem. In the case of a Mr. and Mrs. Brown, which I assume is not a real name, for the purposes of this example, they were told that the appraisal of the rolled up partnership interest that they would receive would be in this case \$19,546 compared to their original \$10,000 investment. They had received \$3,640 in distribution since. And they thought, gee, that sounds pretty good. So they said yes.

I understand that setting an appraisal value on partnership interests is solely for the sake of determining the terms of an exchange. Therefore, it means something other than a normal person—would think it means. I mean, to any of us, to Senator Dodd, to Senator Heinz, to Senator D'Amato, we would think that if the property has been appraised as \$19,546, it probably ought to be worth something close to \$19,546.

Clearly, that wasn't the case. The defense is then this appraisal is just a technical way investment bankers and consultants value things. You shouldn't have paid any attention to that.

Now I don't know what you call that, but I call that just plain misleading.

Chairman BREEDEN. Senator, I would want to answer more generally because I'm not familiar with the case, the specific case you suggested. I don't know whether it's in litigation. I don't know whether it might conceivably be something that the Commission ought to look at. So if you will allow me to answer simply generically—

Senator HEINZ. Generically. I'm not asking you to pass judgment on this specific case.

Chairman BREEDEN. The term that is frequently used, as you were describing it, in some cases they may use appraised value. Most often the term used is exchange value, which is a computational adjustment of how you calculate the value of the units in the different entities that are being rolled up. And so long as, theoretically, if you had an appraised value you could calculate exchange values by multiplying each of the appraised values by 10. So long as you did it consistently for all the rollup partnerships, the pro rata calculation would work that way.

But, yes, an investor could certainly read a document saying, well, we value the exchange value of your partnership as \$100,000, meaning only that that's how we compute what interest you get in the rollup entity compared to the investor in another partnership. And the \$100,000 might bear no relationship to the actual value, would be market value, or—

Senator HEINZ. Why shouldn't it bear a relationship to what in common English parlance would be an appraised value?

Chairman BREEDEN. Well, I wouldn't want to say that people structuring these transactions couldn't make computations as they need to make them. The importance there is to make sure that there isn't discrimination between if you're rolling up four different partnerships, you want to make sure that the partners of each

of the four are treated equally and that you don't discriminate between the four of them.

So there is a function of having one set of computation that tries to cut across all of the individual partnerships that are in that deal to make sure that they are treated consistently.

That may be totally separate and should be clearly stated to be totally separate from what those interests are really worth. And anything that would create the expectation in the investors' minds—

Senator HEINZ. I don't want to put words in your mouth. You're saying, look, if somebody wants to use exchange value somewhere in the explanation of why they got to certain calculations in this deal, fine, they can do that. But they also ought to have real appraisal information so people can figure out what that exchange value is.

Chairman BREEDEN. Yes. Well, I think it's—

Senator HEINZ. Are you saying investors should know how the exchange value relates to any appraisal value? Is that what you're saying?

Chairman BREEDEN. Well, I certainly agree that they ought to—the document ought to have information in there so that investors can determine what they're getting and what they're giving up. If you had four partnerships and each one invested all of its assets in one office building and three of the partnerships owned empty buildings and one of the partnerships owned a fully leased valuable building, you certainly would want the investors in the partnership that had the valuable building to understand that they have a valuable asset with a pro rata value to them of x . After they're rolled up with the people who have worthless assets, they will own a proportionate share of the assets' value—

Senator DODD. Now there's a form of discrimination in a sense. I mean, because assuming the first investor was a prudent investor and did his or her homework in examining the value of that limited partnership. Arguably, the other three did not. And so when you come down you roll them, you have discriminated against the prudent investor without any opportunity for that prudent investor to extricate himself out of the deal.

Chairman BREEDEN. Yes, I know. It is important to emphasize, however, that this prudent investor could vote against the proposed rollup.

Senator HEINZ. I've got an even tougher question for you if you'll give me time to ask it.

I'll state a personal point of view and then I'm going to give you a really interesting and tough example to deal with.

My personal view is that there ought to be a reconciliation, a reconciliation spelled out in any disclosure document between so-called exchange value, which are kind of an inflated, artificial value, and actual value, as determined by a qualified appraiser. There ought to be a—you ought to be able with an appropriate education to read through the document and say, oh, I understand how they got from my investment being worth—I paid \$10,000 for it, it's worth \$11,000. I understand how they got to \$19,000 and what that transaction is all about.

I don't expect you to agree or disagree with me. I'm just telling you what I think.

But let me give you this one. Let's say I'm a general partner and I have four deals. In one I've got a full building, OK, and I've got 100 investors in that deal and it's terrific. I've got three other dogs. I've got three empty buildings, I've got 100 investors in each of those. And I send out a proxy statement which says to all of these people, I think we can have a more successful partnership if we put this one really nice deal in with these three dogs that 300 of you people have. Would the 100 people, if the 300 people make an informed decision, be absolutely up the creek without a paddle because the majority rules?

Chairman BREEDEN. No, Senator, that wouldn't be—

Senator HEINZ. The 300 people are going to clearly be better off being in a rollup with one good property than staying individually in three different deals with three dogs.

Chairman BREEDEN. In virtually—I think in almost every State, the—you would have to get a majority of partners of partnership number one, that each entity to be rolled up has to have a majority of that partnership to join the big rollup.

Senator HEINZ. So that is not a problem?

Chairman BREEDEN. That isn't a problem.

The problem is if the 100 people who get the prospectus in which their valuable asset is being rolled up with 3 or 300 dogs to—that they understand the specific risks and that they not get a whole bunch of general information—

Senator HEINZ. That brings us full circle back to the disclosure question that we were talking about.

Mr. Chairman, I think that Chairman Breeden has been very helpful on this issue and I thank you very much.

Chairman BREEDEN. Senator, if I could just very briefly add also, in agreement to your comments on the exchange value issue, we will look at—I will certainly ask the staff to look at what flexibility we would have to try and either make people use a term like "ratio comparison factor" that avoids the word value, or else make sure that people understand that if they mislead investors as to what value is when they are using a term like value, that there is the potential of a fraud action there if they really trick people in the use of those terms.

Senator HEINZ. Well, Chairman Breeden and Chairman Dodd, anything that can be done to get these disclosures into plain English would be an improvement. You don't need lawyers and accountants to be any more enriched than they already are by our society.

Thank you.

Senator DODD. Mr. Chairman, just a couple more questions. One is, again, I think picking up on the last points putting aside the rights of the shareholders, obviously the word goes out that these are, as they move into a public offering, these are not exactly what you call blue chip, and that's obviously reflected I think in what happens.

And what I think is so surprising and you see within hours literally, in the first day the average drop hovering around 45 percent if you looked at the ones we looked at over the recent times, and I

other interests of the general partner therein, the resulting change in investor rights, and the business prospects and risks of the new entity. Similarly detailed information also is required to be disclosed when the limited partner first acquired the interests subject to the proposed roll-up.

The Commission recognizes that some roll-up transactions may be abusive or unfair to investors in the rolled-up entities. For this reason, we believe concerns expressed by roll-up critics are important and must be given serious attention. However, there are no simple or quick solutions to the perceived problems attendant to these transactions, and certainly none that would warrant either banning roll-ups entirely or subjecting them to extensive federal merit regulation, as some have suggested. For in some circumstances, depending on market conditions and a variety of other factors that typically affect the performance of limited partnerships and other asset-based investment vehicles, participation in roll-ups may offer investors the opportunity to obtain the highest realizable value on their initial investment. Such opportunities should not be foreclosed or impeded by intrusive governmental regulation, particularly at a time when there appears to be so much more to be learned regarding the benefits and risks of roll-ups to investors.

Consistent with the strong disclosure-based policy of the federal securities laws, the Commission is reviewing in depth the current effectiveness of its rules and regulations applicable to roll-ups to determine whether any changes might be necessary to enable investors to weigh, in light of all relevant factors, the appropriateness not only of participation in a proposed roll-up, but also of an initial limited partnership investment. Moreover, the Commission's antifraud enforcement program is focusing on

these transactions to assure that the investing public is not being defrauded. Where fraudulent activity is shown to exist, the Commission will pursue vigorously all available remedies.

As outlined in the introduction, based on its review to date, the Commission has identified several areas for possible regulatory action. Roll-up documents, reflecting both the multiplicity of entities involved and the contractual nature and variability of limited partnerships, are frequently voluminous. In some cases, these documents have been overwhelmingly complex. A principal goal of the Commission's review of roll-up disclosure practices is to provide for a disclosure document that does not, by its sheer size and detail, obscure the fundamentals of the transaction. The Commission will also consider the need for further disclosure guidance in the initial offerings of limited partnership interests.

In addition, the Commission awaits with interest the results of the NASD's possible rulemaking initiative with respect to soliciting dealer's fees. Any NASD proposal in this regard would be submitted to the Commission for approval.

Finally, there have been several suggestions relating to possible improvements in the proxy solicitation process, including the removal of perceived regulatory impediments to discussions between limited partners and others relating to matters subject to a vote, the conduct of non-management solicitations without compliance with the full panoply of proxy rules, the establishment of a mandatory minimum solicitation period, and the provision of an unqualified investor right to a list of limited partners to facilitate inter-investor communication. All of these issues are being reviewed as well in the larger

context of the Commission's ongoing consideration of the voting and proxy solicitation process.

Even as the Commission considers whether revisions of its proxy rules are warranted, it is important to point out that limited partners and unaffiliated third parties have made effective use of the proxy process, either directly or indirectly, to express opposition to proposed roll-ups or to replace existing partnership management. To cite a few examples, a sponsor soliciting investors' votes in support of a consolidation of 14 limited partnerships recently withdrew the proxy statement and abandoned the transaction when confronted with substantial investor dissatisfaction. ^{27/} Limited partners unhappy with the performance of incumbent general partners have conducted solicitations seeking to change control of existing partnerships. In other instances, outside parties have or are attempting to remove general partners in contested proxy solicitations. ^{28/}

^{27/} In another roll-up transaction recently approved by the limited partners, a limited partner formerly associated with the general partners expressed concern over the proposed terms. Following negotiations between the parties, the terms of the transaction were changed to reduce the general partners' ownership interest in the surviving entity.

^{28/} Since January 1, 1990, two general partners have been replaced as a result of proxy contests -- one at four affiliated partnerships, and the other at six affiliated partnerships. In another instance, a REIT that previously terminated an exchange offer for units in four unaffiliated limited partnerships in light of resistance from the general partners has announced its intent to wage a proxy contest for the purpose of installing its own nominee for general partner.

VI. Conclusion

In conclusion, the Commission is well aware of the criticism and controversy regarding roll-ups. The Commission is working, both through its review of particular roll-ups and through its general review of disclosure for roll-ups, to ensure that investors receive complete and comprehensible disclosure, and that all requirements of the federal securities laws are fully observed. Of course, the Commission cannot restore the lost tax benefits, or revise the state partnership laws, that may have contributed to roll-ups or to investor dissatisfaction. The Commission remains dedicated, though, to ensuring that investors receive full and complete disclosure of all information that they need to make their own decisions about proposed roll-ups.

presume that is again related to the notion that these are—because there are so many dogs involved and that's the reaction out there. And I presume some of it has to do with the notion of management, the general partners' role in this and the inability to be able to penetrate that kind of decisionmaking also has a lot to do with what happens to the value of these new entities.

CHANGE IN MANAGEMENT OF THE ORGANIZATION

Chairman BREEDEN. I think there is—I would not disagree with those factors. I might highlight one other problem that goes beyond disclosure and it ties into the establishment of super-majority voting provisions for general partner removal in some of these deals, going from a situation in which in the original partnership you had a right by majority vote to remove the partner to force a change in the management of the organization. And at the end of this larger transaction, you end up with a situation in which the—it takes a super-majority vote to get the general partner out or to make any change.

And that—I have a fairly low personal degree of toleration for devices that are utilized by contract or otherwise to try and cement in management, incumbent management, of an organization that fundamentally operates on the bases of other people's moneys. The general partners usually have invested very little of their own money in the partnership. They're just managing it. And I personally oppose rather strongly devices that are used in State corporate laws to keep shareholders from voting out incompetent management and I would oppose devices that are used in partnerships to keep partners from voting out incompetent or corrupt or overreaching general partners.

And I think we have a problem, I just note, we can't solve fully with disclosure the degree to which State laws have become unduly tolerant of allowing incumbents to be cemented into place, to erect substantial barriers to people voting them out. And, particularly, if then there aren't the strongest possible fiduciary standards to sue those people the investor can find themselves locked into an entity. They can't vote the person out. The person who happens to be in control starts overreaching and taking more and more, and where is the remedy. I can understand the frustration and I do think that to be effective we have to not only have good disclosure but the other two items I mentioned.

We have to have clear and unambiguous fiduciary standards. And States shouldn't create exceptions to fiduciary standards that allow insiders to overreach. And we have to have meaningful voting requirements so that people who are investors know that since it's their money that they have a meaningful franchise. And whether someday we ought to look at a shareholders' bill of rights that establishes Federal voting rights that are unambiguous to make sure the States cannot go beyond a certain point in undercutting voting rights of shareholders or partners is something that over time we may have to look at.

Now, hopefully, the States will solve this problem on their own so no action is needed at the Federal level.

But disclosure can only get at part of the problem. You can have all the information in the world, but if you don't have any voting rights, you don't have good access to a court to vindicate your rights, then the disclosure is not as useful as it might otherwise be.

Senator DODD. Well, I agree. And I think we may be coming to that sooner rather than later. I—the fact that, obviously, the corporate transaction, the shareholder has the opportunity to sell, take a walk, whatever else they want to do and a limited partner does not, as the ground rules are being changed on them dramatically and being drawn into arrangements which they have very little information about and all of a sudden the value of their investment is just all of a sudden depreciated significantly, is I just think bad business and it's going to hurt. And whether or not—obviously, I think these are—there has to be a place for the small investor to be able to move and to be able to get—to be able to take a calculated risk and a calculated high risk, higher risk I should say, and be able to get a return on that investment.

If we don't do it, we will send out a message across this country. We'll watch those numbers just disappear, regardless of what we do with tax laws and so forth on real estate. They just will not play on this, and I wouldn't blame them in light of some of the things that have gone on here; they'd be foolish to. And so I would hope that we might—one, I'm encouraged by what you've said in terms of what the SEC can do with its existing authority.

I realize you're—and by the way, NASD makes some recommendations on readability of these prospectuses and also the notion that the risks involved be highlighted so that they are, you know, typically, it's like anything else. When you're trying to promote something, it's always in the very smallest of print on the very least likely page to be read that you're warned, and by the way.

What we need to do and they recommend is moving that information up so, at least on disclosure, it's quite clear what the risks are involved here as well.

The irony is, again, no matter what you tell them, it's almost a cruel hoax in a way because even if your prospectus and your information in disclosure is the best ever envisioned and created in the mind of man, the problem is that if you know it there's almost a cruelty associated with it because the limited partner can't do a damn thing about it. So almost letting him know all of the worst things that can happen, the fact of the matter is saying, you know, the good news is you're going to be the starting pitcher. But the bad news is it's going to be with that team in heaven and you're not going to make it.

LONG-TERM INVESTMENT

Chairman BREEDEN. I would differ on one point—prominent risk disclosure is required up front in Commission mandates documents. However, I do agree in large part with what you said. And I think basically you and I see pretty much eye to eye on this question. I don't see how we can expect—we should be trying to encourage long-term savings and long-term investment in this country. But if you abuse the people who do invest and who take risks, and it goes

well beyond the Tax Code, although I occasionally mention that subject.

But if we allow the people to have swiped away from them the fruits of good investing or allow themselves to be in a situation where insiders are able to divert to their own pockets the shareholders' value with fairly low accountability, it will diminish the attractiveness of investing in this country and the result will be higher-cost capital for every company from coast to coast that wants to do research or build plant or equipment.

Senator DODD. I'm glad you made that point.

Chairman BREEDEN. It isn't true that in this area limited partners have no ability to protect themselves because before they can get rolled up, they do get a chance to vote. And to hark back to Nancy Reagan, there is a philosophy of just say no. If they do get this better disclosure and they understand it, they should have an ability to say this is a dumb deal, I'm not interested in it, and vote no.

COMPENSATING BROKERS FOR YES VOTES

One of the things in addition to better disclosure that I very much want to look at is this whole process of compensating broker-dealers for coming up with yes votes, because that gets into the sales practice use.

Senator DODD. That's an understatement. It gets into the sales practice.

Chairman BREEDEN. Yes. We may deliver to somebody a beautifully written prospectus that may lay out the summaries, but if the people who are on the telephone to them have a personal monetary interest in making them vote only one way, somehow I suspect that that written document is going to get overlooked in the pressure of the telephone calls.

So I would personally like to see us move quite vigorously in the direction of saying, if you want to compensate brokers, then you compensate them for coming up with a vote, whether the vote is a yes vote or a no vote, so that the brokers are not under any personal conflict in telling their investors, look, this is going to hurt you, you ought to vote no.

But today that isn't the case in many of the transactions.

Senator DODD. No, and part of the other suggestion is, again, and I realize you don't want to be putting out information way in advance when things are not actually a reality, but the flow of that information, going back to the flow of information where limited partners have the opportunity to get together and have some sort of a communication ability so that if there is a growing consensus that something's bad about this operation that they have some opportunity to work with one another. Obviously that's the last thing the general partners are going to want to do at the time they're trying to make sure they cover their behinds on the bad deals they're in.

But as you pointed out, it's not their money. It's not their money.

Chairman BREEDEN. Right.

Senator DODD. Those people ought to be able to have the right to be able to get together to be able to decide in one formal matter or

another with enough adequate time so they can decide in some way that this is something they don't want to do. I mean, obviously, the general partners are getting together and they're making sure that the yes votes are getting together. And the last thing they want to do is to make sure that anybody who would look at this thing would consider you had to be nuts to allow a yes vote on this kind of a thing.

So I'm pleased to hear you say all of those things. And again, you're absolutely correct. The bottom line is cost of capital, because that's what we're really talking about here.

I have to ask you one quick question because it's a related but not a direct matter. And that is, we get, you know, very uneasy during these times of recession and so forth about people and financial officers within corporations about cooking up some books to make things look a little bit better, to put it mildly, than they may be. And obviously this falls within the area of due vigilance on the part of the SEC to look into the accounting practices and so forth.

I just wondered if you might give us a notion of what your message would be to accounting officers in firms and what the implications might be. Or is it what the SEC is doing about this at this particular time in light of the fact that this is not a new phenomenon. When you do end up with these periods of downturns it's for obvious reasons, the last thing people want to be putting out is accurate information in some cases about what's actually going on.

Chairman BREEDEN. Mr. Chairman, I think you're exactly right that certainly in times of economic downturn, whether nationally or regionally, there can be greater pressure on firms that are facing declining results to make the results look better than they were able to actually achieve as managers. And we—a very major concern of the Commission always is distortion of reported financial statements.

The only way you can have a market economy in which the market sorts out who the winners and the losers are is that you require the market's impact to be accurately reflected to people. And if you let people win back through falsification of accounting statements what they lost in the marketplace, you will blur and eliminate the message of the market about which companies are being well run and which ones are not.

So we do care about this at all times. We try to be extremely vigilant in good times and bad and we bring actions against it.

The recent case we brought against the Bank of New England being one example of a case where a firm, under desperate pressure to raise capital, in this case to stave off a possible takeover of the bank, chose to go out and do a \$200 million public offering knowing that its real estate portfolio was worth \$1½ billion less than it said it was worth in the offering documents. And, as soon as the offering closed 2 or 3 weeks later, they announced that they were taking \$1½ billion writeoff.

Now they knew at the time they did the offering that they were going to take that writeoff and, in fact, well before the Comptroller of the Currency had told the bank officers in writing that they were going to have to take a writeoff. And they conveniently man-

aged to overlook that until after they had gone out and got the public's money in.

We brought fraud charges against them and obtained settlement of that case. We will sue and use every enforcement tool at our command in similar cases where you have managements of firms cooking the books or otherwise distorting financial statements in order to mislead people into either investing or not selling out or—it doesn't have to be solely in the public offering context. We care equally in terms of just reporting to the marketplace what your ongoing results are.

Senator DODD. Well, I'm delighted to hear you say that. That's good. That message will help get out during these times that they better beware, that you're watching.

Chairman BREEDEN. Well, I hope so. I would—you know, accounting matters sometimes are taken as kind of arcane things and not everybody understands all the accounting literature that's out there and I certainly can't blame people for that because it can get very complex. But we do maintain hundreds of accountants at the Commission and are constantly searching for a good accounting staff to make sure that we keep a pressure on people to know that we require audited financial statements and we require compliance with those accounting guidelines.

And it isn't something that's merely technical. It goes to the very heart of being able to—of not allowing companies to try and portray themselves as being better off than they really are, and that that is a fundamental right of investors to expect that they will get the truth, and the full truth, and it isn't going to be doctored and dressed up in a way that isn't acceptable and we will sue and people should be aware of that. And when they are being under pressure, they should spend their time thinking about how to be more successful in business and not spend their time thinking about how they can doctor the books because we will try and bring the most severe sanctions in those cases.

Senator DODD. Mr. Chairman, we thank you. I am about 4 minutes late. I promised you noon and it's 4 minutes after. And I apologize to you. I hope you make your flight.

But this has been tremendously helpful, as always, and really appreciate your interest and your concern about this question and I think you framed it very reasonably.

And I know you feel this way, and I do as well. This is not an effort to kill limited partnerships. It's been a very attractive vehicle and certainly can continue to be so. It's certainly not my intention to discourage that at all. But as you've described it properly, to make sure it's done right and proper and make sure we increase small investor confidence in this market. And I thank you for being here.

Our last panel of witnesses are Frank J. Wilson, the general counsel, executive vice president of the National Association of Securities Dealers and Dee Harris who is the director of the Arizona Securities Division.

We welcome you here, apologize for being a little bit late, and we're going to move right along here with you.

We're going to move some of those plaques up there. We'll ask the staff if they might take down Chairman Breeden's, Mr. Errickson's so I——

All right. Well, thank you gentlemen for being with us. Mr. Wilson, we appreciate your being with us today and Dee as well. And give us some sense of what's going on out in one State anyway and some of the comments made by the Chairman of the SEC I think might be helpful.

Anyway, why don't we jump right in and I would ask you, if you've got a lengthy statement, to try and summarize it so we can get to some questions with you. I promise you every word you have written in those statements will be in the record.

STATEMENT OF FRANK J. WILSON, GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS OF WASHINGTON, DC

Mr. WILSON. Yes. I have a short statement that would take about 7 or 8 minutes, I think, Mr. Chairman.

Senator DODD. Fine.

Mr. WILSON. But at any rate we thank you for the opportunity to appear here and would like to note that one of the standing committees on the NASD Board, the Direct Participation Programs Committee, is now considering the abuses inherent in rolled up limited partnerships. And recently, on its recommendation, the Board approved for publication for comment a proposal which would have the effect of preventing differential compensation in connection with the votes on rollups.

I would like to say that the Board's initiative on differential compensation is the only definitive position that the NASD has expressed so far in the rollup area. And that's not yet final.

Therefore, opinions expressed by me today should be considered my own. But I can assure you that the NASD is aggressively looking at the rollup area in addition to the area of markups in connection with secondary market transactions and limited partnerships.

Ninety-one percent of the commentators, or 49 of 54 on our proposal believe that the practice of general partners paying for only yes votes was unfair and should be prohibited. They believe that differential compensation creates an actual or perceived conflict of interest for the broker while virtually guaranteeing the general partner that the rollup will be approved. Now this is to the potential detriment of the limited partner investors.

These 54 comment letters also contained extensive discussions of other problems that these commentators saw in the rollups. Among those are lack of dissenters' rights, the installation of super majority voting rights to change from a finite to infinite life investment, acceleration of general partners previously subordinated interest, change in management fees from operations based to asset based, lack of disclosure of the negative aspects of the rollup, and incomprehensible disclosure. In many cases, lack of summaries in plain English.

And also inherent conflicts of interest and the lack of arm's length bargaining when the general partner recommends transactions from which it will benefit.

The purpose of rollups, according to the general partners that propose them, is to reduce expenses by taking advantage of economies of scale and management, and to provide liquidity to the limited partners by listing on an organized securities market.

Other, more cynical observers view rollups as merely a device used by the sponsor/general partner to accelerate and perpetuate its management and other fees by converting a finite investment of 7 to 10 years to an infinite investment with no requirement to distribute the proceeds of any liquidated assets to investors.

Unfortunately, there's much evidence to support the latter view.

Combining independent, nontraded limited partnerships into a new publicly traded entity, proponents of the concept argue, provides liquidity to limited partners who desire a way to liquidate their investments.

The principal disadvantage of that is that such liquidity is only available at a heavily discounted price.

Other disadvantages include:

The fees paid by the partnerships to professionals, such as lawyers, accountants, financial advisers, which further reduces the value of the partnership securities in the aftermarket, and directly dilutes the amount of money available to work for the limited partners.

Dilution of the value of good partnerships, when combined with those which are not so successful.

The change from the finite to an infinite life such that the liquidation proceeds are not required to be distributed to the limited partners at the expiration of the original term, but the general partner receives fees forever on a basis preferential to that under the previous partnerships.

The accelerated interest of the general partner from a subordinated interest to an equity interest.

These disadvantages, as I see them, are all at the expense of the limited partners.

Post reorganization performance of the new, publicly traded entity is invariably disappointing.

The value of the interests in publicly traded entities resulting from rollups have, in virtually all cases, traded down.

And I believe other testimony today has demonstrated that point exhaustively.

The documents which the partners use to vote do not usually contain an easy-to-understand summary of the advantages and disadvantages of the transaction, or of the trading history of these issues.

Disclosure is really both exhaustive and exhausting to read.

Limited partnership investors are generally retail customers who are intimidated by the sheer size, weight, and complexity of the documents.

Readability would be greatly enhanced if plain English techniques were employed, and negative aspects of the rollups were more prominently displayed up front and in understandable fashion.

Important, also, would be disclosure of the typically poor after market performance, once the rollup is completed.

We see, based on the letters that we've received, at least a couple of trends in the area.

One is that the increased scrutiny and publicity of rollup abuses in the past few months has resulted in increased pressure on general partners, affecting the way they structure these transactions.

This would appear to be most positive.

Another trend we see is reflected in the comment letters we receive, which indicates increasing reluctance by NASD members to solicit approval for these transactions, because they don't believe rollups have a high probability of delivering the benefits promised by general partners.

Also, more than one letter said the professionals, themselves, have trouble understanding them because of their complexity, their length, and their detail.

And I think this is amply demonstrated by one of the letters that we received.

And, if I could take a second, I'll just read from that letter.

This is from an experienced professional.

And he says:

To begin with, these extremely complicated transactions typically occupy myself, a knowledgeable securities attorney . . .

That's him talking, not me.

. . . a knowledgeable securities attorney, and my two very experienced rollup analysts at least 2 weeks to fully review, research, and understand the proposed transaction. We then have 2 weeks remaining, usually, to attempt to educate, communicate, and fully explain the transaction's merits to our representatives and/or their clients.

And then he goes on, and he concludes by saying:

How, then, can a limited partner possibly make heads or tails of this situation in such a short time, with such typically biased information.

And just to further illustrate that point, here's one of the documents he was talking about that have to be analyzed, reviewed, and a limited partner is supposed to understand what he reads.

Senator DODD. How many pages, roughly, is that?

Mr. WILSON. I'll tell you exactly.

I hasten to add, I have not read this. [Laughter.]

Seven hundred and thirty pages.

And I hasten to add that probably it's a safe bet that not one of the 127,000 limited partners that were involved in this has read this.

I think it would probably be a safe bet.

Senator DODD. You'd guess that it's probably been, in fact, the size of that was calculated and prepared that size for the very reason that it would not be read?

Mr. WILSON. That's right.

Well, maybe. I can't—I don't want to comment on that, because I don't know.

Now, this is probably one of the larger, if not the largest.

However, I'm told that the average size would be somewhere around half of this, so you're still talking about a pretty substantial document.

Senator DODD. Is this a completed one?

Is this one that's already been sold?

Mr. WILSON. Pardon me?

Senator DODD. Is this one that's already been out?

Mr. WILSON. Yes, I think it was voted on last week, February 19, 1991, I believe.

Senator DODD. Is it being offered publicly?

Mr. WILSON. It's an exchange offering, and I believe it was approved.

Senator DODD. I'm just curious as to what the value, what happened to the value of it, it's appraised value, when it went on as a public offer.

Mr. WILSON. I do not know the answer to that, sitting here.

We can find that out for the record.

Senator DODD. I'd be interested to see whether or not it's sort of lining up with what we reported on some of these other ones occurring.

Mr. WILSON. OK.

A couple of more comments, if I might, Mr. Chairman.

In my view, rollups present an inherent conflict in that the general partners have a fiduciary responsibility to act in the interests of their limited partners, while, at the same time, they're also structuring the terms of the rollups to favor themselves.

Under general partnership law, the general partner has a fiduciary duty to act in the utmost good faith and in the best interests of the limited partners.

I think it's high time someone challenged the rollup on the basis of breach of fiduciary responsibility.

Proxy process improvements are needed to counter the inability of securities dealers to freely advise their customers on rollups without running afoul of the proxy rules.

They're concerned that the current proxy rules prohibit them from affirmatively recommending that their individual investor clients vote "no," on the rollup, particularly when other brokers may be soliciting their clients' "yes" vote.

Your letter asked us whether we saw any structural safeguards that could be needed.

And we think that there are some, among which the following could be included:

General partners could be required to provide alternatives to dissenters to the rollup, such as a cash payout, a note, or the option of maintaining the original partnership investment, so that limited partners have a choice.

Dissenters should have some rights, especially if the proxy process doesn't change, so as to enable client counseling to vote "no."

General partners or sponsors proposing the rollup could be required to incur the costs of the solicitation, instead of the limited partners, particularly in the case of a negative vote, so as to eliminate the unfair financial burden on limited partners, and to provide an incentive for general partners to structure the rollup in a manner beneficial to limited partners.

General partners could be prohibited from accelerating their subordinated backend interest into an equity interest, and changing their management fees from an operations-based to an asset-based fee, to the clear and extreme detriment of limited partners.

Partnership agreements in newly formed partnerships could contain provisions that protect limited partners in the event of a rollup.

And general partners could be prohibited from installing super-majority voting rights, unless they were included in all of the original partnerships.

And the partnerships could be required to provide detailed financials by property, rather than consolidated reports as they do today.

Detailed reports would provide the information necessary for the market to value the securities resulting from the rollup.

In summary, although the NASD's role in this area has been limited thus far, we believe our proposal to eliminate differential compensation for "yes" votes is an important step in curbing abusive rollups.

If members can, instead, make objective recommendations to their clients, unswayed by compensation arrangements, general partners will be forced to structure fairer transactions, as well as provide more desirable alternatives for the limited partners.

Soon our committee will be meeting to look at the results of the comments on the differential compensation, as well as look at other potential areas that might be the subject of rules and regulations in the future in a number of those areas that have been discussed here today.

Thank you, Mr. Chairman.

[The complete prepared statement of Frank J. Wilson follows:]



Testimony of Frank J. Wilson
Executive Vice President, Law and Regulatory Policy, and General Counsel
National Association of Securities Dealers, Inc.

Before a Hearing of the
Subcommittee on Securities of the
Committee on Banking, Housing, and Urban Affairs
United States Senate

Concerning

Partnership Roll Ups

February 27, 1991

I am Frank J. Wilson, Executive Vice President, Law and Regulatory Policy and General Counsel of the National Association of Securities Dealers, Inc. (NASD). The NASD is pleased to have this opportunity to appear before you today to discuss limited partnership reorganizations, referred to as "roll ups." After describing my organization and its role in this area, I will address the areas of concern in the order that they were set out in your invitation to testify.

I. The NASD

The NASD is registered with the Securities and Exchange Commission (SEC) as a national securities association under the Securities Exchange Act of 1934. The NASD is the only association so registered. It is a regulator and a market operator. As a market operator it runs the National Association of Securities Dealers Automated Quotation System, or NASDAQ Stock Market, which is the second largest securities market in the United States and the third largest in the world. As a regulator it is charged with the responsibility of regulating both NASDAQ and the over-the-counter securities markets. This task encompasses both regulation of NASD member broker-dealer firms and the regulation and operation of the NASDAQ system as well as, within the scope of the pertinent securities acts, the municipal and government securities markets.

The NASD has 5,827 broker-dealer members employing 410,000 registered sales persons and principals. Some 4,600 securities issued by 4,100 companies are quoted on the NASDAQ Stock Market and 417 NASD members serve as market makers in those securities.

The scope of the NASD's regulatory jurisdiction extends to all such members and their associated persons. While the 2,270 staff of the SEC and roughly half that number of state securities regulatory staff must deal with all aspects of securities regulation, the 1,980 staff of the NASD focuses on regulation of its members and the operation of its stock market, which is only a segment of federal and state regulation. Through close cooperation with federal and state regulators, overlap and duplication is minimized, freeing governmental resources for securities regulation to be focused on other areas.

The NASD carries out its examination, disciplinary, and other regulatory responsibilities through its Washington headquarters and 11 District Offices located in major cities throughout the country. In addition to disciplinary committees that work with each District Office, the NASD has a national Market Surveillance Committee that deals specifically with market and trading related issues. A committee of the NASD Board of Governors, the National Business Conduct Committee, reviews as an appellate body the disciplinary activities of the District Business Conduct Committees and the Market Surveillance Committee, and seeks, to the extent possible, uniformity in disciplinary actions. Final NASD disciplinary actions can be appealed to the SEC and then to the United States Courts of Appeals.

The NASD is governed by a 30 member Board of Governors drawn from its membership, leaders of industry and academia, and executives of NASDAQ companies. The Board, through a series of standing and select committees, monitors trends in the industry and promulgates rules, guidelines, and policies that it deems necessary to protect investors and the markets.

One of the standing committees, the Direct Participation Programs/Real Estate Committee is currently considering the abuses that exist when general partners roll up existing partnerships into master limited partnerships, real estate investment trusts (REITs) and corporate entities that trade on organized markets. Any action that this committee believes should be taken to regulate these abuses will be referred to the Board of Governors. If approved by the Board, a filing will be made with the SEC to amend our rules.

The NASDAQ stock market is a highly visible screen-based market with intense competition between market makers. Their bid and offer quotations are continuously displayed over thousands of subscriber terminals, with real-time transaction reports for all NASDAQ/National Market System stocks. Ownership and participation by investors in the NASDAQ market is broad and diverse. Individual investors own approximately two-thirds of the market value of NASDAQ stocks. Institutional investors are also very active in NASDAQ -- and are becoming a growing part of our market -- but individual participation is paramount, thus the NASD is concerned with the perceptions of individual investors about today's markets. Investor protection is the cornerstone of the NASD's regulatory and enforcement efforts.

A. Limited Partnership Roll Ups and the NASD

Limited partnerships, sometimes called direct participation programs because of the flow-through of tax benefits directly to investors, are entities that consist of a general partner or sponsor, who manages the project, and limited partners, who invest money but have limited liability -- so they cannot lose more than their capital contributions -- and are not involved in the day to day management of the project. Limited partners usually receive income, capital gains and tax benefits and have a priority on the profits derived from asset sales of the project. The general partner is usually a knowledgeable individual who puts up some of the money for the project, receives a sizable share of the profits, is assured of income while the project operates, and accepts liability for losses in excess of partnership capital. The general partner has a subordinated interest to the limited partners in the proceeds generated from the sale of assets. Limited partnerships invest in real estate, oil and gas, and equipment leasing, but they can also finance research and development, movies, and other projects, and generally are attractive because they flow profits through the partnership to limited partners without taxation at the partnership level. Typically, public limited partnerships are sold through brokerage firms for minimum investments of \$2 to \$5 thousand, with a typical investment of less than \$10 thousand.

Although roll ups are very complex, they can basically be described as transactions in which a number of limited partnerships are combined into a single entity that will trade publicly.

Under Article III, Section 34 of the NASD Rules of Fair Practice, the NASD is authorized, for the purpose of preventing fraudulent and manipulative acts and practices, promoting just and equitable principles of trade, and for the protection of investors and the public interest, to adopt rules, regulations and procedures prescribing standards of fairness and reasonableness for direct participation programs relating to: 1) the underwriting or other terms and conditions concerning the distribution of such programs to the public, and 2) the terms and conditions concerning the operations, structure and management of such programs in which a member or an affiliate of a member is a sponsor. However, it must be noted at the outset that the NASD does not have rules that regulate non-NASD members, including sponsors and general partners responsible for many of the perceived abuses involved in partnership roll up transactions, and does not have authority to adopt rules directly regulating those persons.

Despite the fact that authority to adopt rules regulating sponsors affiliated with NASD members is contained in our Rules of Fair Practice, specific guidelines were not adopted under that provision because of North American Securities Administrators Association, Inc. (NASAA) guidelines that regulate all sponsors at the state level, not just sponsors affiliated with our members. Since our rules are developed in uniformity and coordination with state securities laws, the NASD and the SEC reached a determination that, in light of the NASAA guidelines and their application to all sponsors, extensive NASD rules regulating sponsors are unnecessary.

The NASD has adopted rules under Appendix F to Article III, Section 34 of the Rules of Practice establishing guidelines for fairness and reasonableness of underwriting compensation and distribution arrangements when NASD members participate in the issuance of public partnership interests, and the solicitation of consents of limited partners to approve roll up transactions. We review both the types and amounts of compensation to be received by our members. With respect to the amount of compensation, we have a 10% compensation guideline which limits the amount of underwriting compensation that may be received by our members in connection with the public offering of a partnership. Most roll up transactions provide for a 2% payment to NASD member firms for each "yes" vote solicited, an amount well within the guideline. While the amount of compensation is considered fair and reasonable, the NASD is questioning the fairness and reasonableness of members receiving compensation only when soliciting "yes" votes and has proposed to eliminate the practice. Members also sometimes receive engagement fees, financial advisory fees, and fees for providing fairness opinions in connection with roll up transactions.

NASD members are also required by the Rules of Fair Practice, when recommending the purchase, sale, or exchange of a partnership unit, to make a determination that the investment is suitable for the customer, taking into consideration the customer's investment objectives, financial situation and needs, tax status, and any other information known to the member.

While underwriting and distribution arrangements, as well as sales practices, are regulated by the NASD, the great majority of the problems that lead to the complaints that we all hear about regarding these roll up transactions involve the general partners, who are not normally NASD members, and therefore fall outside our jurisdiction.

NASD

Notice To Members

National Association of Securities Dealers, Inc.

December 1990

Number 90 - 79

Suggested Routing:*

- ☒ Senior Management
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- ☐ Trading
- ☐ Training

*These are suggested departments only. Others may be appropriate for your firm.

REQUEST FOR COMMENTS

Subject: Receipt of Differential Compensation for Soliciting Proxies in Partnership Roll-Ups;
Last Date for Comments: January 15, 1991

EXECUTIVE SUMMARY

The NASD requests comments on a proposed amendment to Appendix F under Article III, Section 3 of the Rules of Practice ("Appendix F") that would prohibit member firms from receiving limited partnership compensation connected with investor votes in connection with the roll-up of limited partnerships. In response to this action, the text of the proposed amendment follows this notice. The amendment is intended to receive comment from regulatory authorities to the NASD.

NASD members soliciting limited partners in a roll-up to receive a commission only when the investor votes "yes" on the proposed transaction. The NASD is concerned that the payment for "yes" votes raises a conflict of interest, or appearance of a conflict of interest, since such a compensation arrangement may give members an incentive to recommend approval of the transaction.

A typical differential compensation arrangement provides for members to receive a commission, generally around 2 percent, for soliciting "yes" votes from limited partners to approve a roll-up transaction. No payments are made for "no" votes. In addition, members do not receive these commissions if a sufficient number of "yes" votes is not received to consummate the transaction. Members also sometimes receive engagement fees, financial advisory fees, and/or fees for providing fairness opinions in connection with roll-up transactions.

On October 3, 1990, the House Subcommittee on Telecommunications and Finance opened hearings in Washington, D.C., on various investor protection, fairness, and disclosure issues related to the roll-up of limited partnerships.

The subcommittee indicated its intention to convene a series of hearings to determine whether

BACKGROUND

The NASD's Direct Participation Programs/Real Estate Committee, a national standing committee of the Board of Governors, has reviewed certain issues relating to NASD members' activities in connection with the roll-up of existing limited partnerships into new publicly traded limited partnerships, real estate investment trusts, or corporations.

In particular, the Committee reviewed the use of differential compensation plans that provide for

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legislative or regulatory action is necessary to curb perceived abuses in the roll-up area.

Such perceived abuses relate to the fees earned by general partners and their affiliates in connection with roll-up transactions, poor after-market performance of entities resulting from a roll-up, the lack of dissenters' rights for limited partners opposed to a roll-up, the accuracy and adequacy of disclosure documents provided to investors considering a roll-up, as well as differential compensation arrangements providing payment to brokers only when soliciting "yes" votes.

The NASD believes that the appropriate legislative or regulatory bodies should address concerns relating to investor protection, aftermarket performance, fairness, and disclosure in connection with roll-ups. The issue of differential compensation, however, presents an immediate issue to the NASD. The Board of Governors is concerned about members' receipt of payment only for "yes" votes when soliciting limited partners considering approval of a roll-up transaction, particularly in light of the above-referenced investor protection, aftermarket performance, fairness, and disclosure concerns relating to these transactions.

The Board questioned whether members should be paid only for soliciting "yes" votes when it is unclear whether such "yes" votes are in the best interests of investors. The Board determined that it may be more appropriate for members to receive a solicitation fee based on delivering any vote, "yes" or "no," as compensation for their solicitation efforts.

Therefore, the Board of Governors accepted the Direct Participation Programs/Real Estate Committee's recommendation to request membership comment on a proposed amendment to Appendix F under Article III, Section 34 of the Rules of Fair Practice. The proposed amendment would prohibit the receipt by a member of differential compensation in a roll-up transaction that is tied to the solicitation of "yes" votes only from limited partners, irrespective of the form of entity resulting from the roll-up (i.e., a partnership, real estate investment trust, or corporation).

REQUEST FOR COMMENT

The NASD is requesting comment on the proposed amendment itself as well as specific comment on several unresolved issues relating to the proposed amendment and roll-ups.

First is the question of whether the 2 percent commission creates a conflict of interest sufficient to sway members to solicit "yes" votes when the member believes the roll-up transaction is inappropriate or disadvantageous to its clients.

Second, if payments for "yes" votes are prohibited, should members be permitted to receive commissions contingent on a sufficient number of "yes" votes being received to approve the transaction? If members know they will be compensated only if the transaction is approved, despite the fact that they can receive compensation for "yes" and "no" votes, there might still exist an incentive to recommend that limited partners vote "yes."

Third, members are requested to comment on whether viable alternatives exist that would address the differential compensation question without adopting a prohibition on its receipt. Commenters are encouraged to propose other methods of regulating this practice. Alternatives include (1) expanding or modifying the disclosure requirements relating to differential compensation and (2) requiring the soliciting broker-dealer to affirmatively inform the limited partner of the potential receipt of differential compensation.

* * * * *

The NASD Board of Governors encourages comment from all members and other interested persons. Comments should be directed to:

Mr. Lynn Nellius, Secretary
National Association of
Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506.

Comments must be received no later than January 15, 1991. Comments received by this date will be considered by the NASD's Direct Participation Programs/Real Estate Committee, other appropriate standing committees, and the NASD Board of Governors. If the Board approves the proposed amendment to Appendix F, it must be filed with and approved by the Securities and Exchange Commission before becoming effective.

Questions concerning this notice may be directed to Richard J. Fortwengler, Associate Direc-

Senator DODD. I appreciate it very, very much, Mr. Wilson.
Mr. Harris, we thank you for being here.

STATEMENT OF DEE HARRIS, DIRECTOR, ARIZONA DIVISION OF SECURITIES, ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. HARRIS. Mr. Chairman, good afternoon.

I am Dee Harris, the Arizona Director of Securities.

I also serve as the chairman of the Limited Partnership Roll-Up Task Force of the North American Securities Administrators Association, NASAA.

In the United States, NASAA is the national voice of the 50 State agencies responsible for small investor protection and the efficient functioning of the capital markets at the grassroots level.

I appreciate the opportunity to appear before you today.

I want to begin by sharing with you, the grave concerns of States securities regulators across the Nation about the growing number of complaints that we are hearing from both small investors and market professionals who see abusive rollups as a serious and worsening problem.

This is a particularly frustrating situation for States securities regulators who have devoted many long years to framing and using a State level system of fair and reasonable regulation for publicly offered limited partnerships.

Fifteen years of concerted State efforts to police limited partnership offerings have resulted in a marketplace that is both much fairer and relatively free of fraud and abuse.

We are dismayed that all of this good work on behalf of small investors is now being unraveled and undercut by the rising tide of rollups.

The plain truth is that those small investors in limited partnerships whom the States now do such a good job of protecting are stripped in the rollup process of every single major safeguard.

How does this regulatory "disconnect" come about, and why are State regulators out of the rollup picture?

State securities laws focus on risky and illiquid investments where it can be said that no efficient market exists.

That is why so much of the attention of the States falls on such instruments as penny stocks and limited partnerships.

It is these instruments where there is the greatest danger for fraud and abuse.

For the SEC is reserved the role of coping with regulatory issues of a truly national and marketwide scope.

This regulatory burden sharing also explains why it is that the States, out of respect for the concept of a national market system, have adopted exemptions for securities listed on exchanges upon which almost all rollups are listed and traded.

From a regulatory standpoint, the problem of rollups is that they embody the worst of the characteristics that normally trigger State oversight, while also managing to be national in nature.

It is this "betwixt and between way" that a rollup transaction moves from the small investor focus of State regulation to the

B. The NASD's Differential Compensation Proposal

On October 30, 1991, the NASD's Direct Participation Programs/Real Estate Committee determined to recommend that the Board of Governors authorize a Notice to Members requesting membership comment on a proposed amendment to Appendix F to Article III, Section 34 of the Rules of Fair Practice that would prohibit our members from receiving differential compensation in soliciting consents to roll up transactions. Ninety-one percent of the commenters (49 of 54) believe that the practice of general partners paying only for "yes" votes is unfair and should be prohibited. The commenters agree that differential compensation creates an actual or perceived conflict of interest for the broker while virtually guaranteeing that the roll up will be approved, potentially to the detriment of the limited partner investors.

Our proposal is designed to eliminate any conflict that our members may have in making a recommendation to a limited partner considering a roll up. The proposed prohibition on differential compensation is expected to eliminate the incentive to recommend approval of the transaction and permit members to advise customers based on their objective evaluation of the disadvantages and advantages of the transaction. The only negative impact of this approach is that if payment must be made for either "yes" or "no" votes, the cost of the transaction is increased. While such costs are likely to be passed on to the limited partners themselves, that disadvantage would likely be outweighed by the more objective advice the limited partners should receive under the proposal. If the costs of the solicitation were required to be paid by the general partner in the case of a negative vote, that negative impact would be erased.

The 54 comment letters we received in connection with our proposed prohibition on differential compensation were interesting in that they often contained extensive discussions of other problems the commenters have identified with roll up transactions, including the:

- Lack of dissenters' rights
- Installation of super-majority voting rights
- Change from finite to infinite life investment
- Acceleration of general partners' previously subordinated interest
- Lack of disclosure of the negative aspects of a roll up
- Incomprehensible disclosure -- lack of summaries and the need for plain English
- Inherent conflicts of interest when the general partner recommends transactions from which it will benefit and lack of arm's length bargaining
- Change in general partner fee structure from an operations-based to an asset-based structure.

Our members' comments create a context for our responses to the questions posed in your invitation letter. A copy of our Notice to Members and list of the commenters is attached, and we have provided copies of the letters to the Committee.

II. Issues

I will now proceed to respond to the concerns contained in your invitation letter. Please keep in mind that the NASD Board had not yet had an opportunity to review many of the abuses noted in our members' comment letters. However, the NASD is in the process of reviewing roll up practices and will express its views after our Board has an opportunity to consider them. Therefore any opinions expressed today should be considered my own.

A. Purpose of Reorganization

It is our understanding that the purpose of these reorganizations, according to the general partners that propose them, is to reduce expenses by taking advantage of economies of scale in management and to provide liquidity to the limited partners by listing on an organized securities market. Sponsors that have a number of partnerships, each of which had typically proposed to liquidate in 7-10 years, find it difficult or impossible to liquidate the partnership portfolios at a price that would be advantageous to the investors. As an alternative to liquidating the portfolio and distributing the proceeds to investors, they determine to provide liquidity by rolling up the partnerships into one publicly-traded instrument, thereby allowing investors the opportunity to sell their interests. After the roll up, the administrative and management functions of each partnership can be centralized, which ostensibly reduces costs.

Other, more cynical observers view roll ups merely as a device used by the sponsor/general partner to accelerate and perpetuate its management and other fees by converting a finite investment of 7-10 years to an infinite investment with no requirement to distribute the proceeds of any liquidated assets to investors.

B. Advantages and Disadvantages of Combining Independent Non-traded Limited Partnerships into a New Publicly-traded Entity

The principal advantage touted by those that propose roll ups is liquidity, since sponsors and general partners assert that limited partners desire a way to liquidate their investments. The principal disadvantage is that such liquidity is only available at a heavily discounted price. Other disadvantages include: dilution of good properties by rolling up them with the bad, the change from finite to infinite life such that liquidation proceeds are not required to be distributed to limited partners, change in fee structure that very often results in increased fees for the general partners, and the accelerated interest of the general partner from a subordinated interest to an equity interest. All of these disadvantages are at the expense of the limited partners.

C. Reorganization's Impact on Limited Partners

The most dramatic impact on limited partners seems to be the deep discount in the publicly traded market for their securities. Other impacts include the fees paid by the

partnerships to professionals such as lawyers, accountants, and financial advisers, which further reduces the value of the partnership securities in the after-market.

Further, in the original partnerships, the general partner's compensation is based on front end fees received directly from the offering proceeds, a portion of cash available for distribution received on an ongoing basis during the life of the partnership, and a share of profits achieved after the sale of assets. Since the general partner's share of the cash available for distribution is expressed as a percentage of distributions to limited partners, cash flow must remain constant or increase in order for the general partner's compensation to remain steady. Given the current economic climate, particularly in real estate, a general partner's compensation from cash available for distribution has fallen off substantially. After the roll up, the compensation is often based on the amount of assets under management. Thus, rather than relying on cash flow the general partner can depend on assets under management. Therefore the entity does not have to be profitable ever again for the general partner to be paid. Obviously, this is to the detriment of the limited partners.

Finally, by combining the revenue streams of good and bad partnerships into a new entity, a roll up tends to dilute the return of limited partners whose partnerships are performing well. The good partnerships offset the performance of the bad partnerships, thus reducing general partner liability for non-performing properties while permitting the general partner to receive an asset-based fee that ensures the general partner a healthy income stream. Limited partners of the good partnerships are thus harmed.

D. Post Reorganization Performance of the New Publicly-traded Entity

The value of the interests in publicly-traded entities resulting from roll ups have, in virtually all cases, traded down from the exchange value. It is not unusual for the securities to trade down 40% in the first 30 days of trading, and further declines of 55% to 95% are possible.

E. Adequacy of the Current Regulatory Structure and Federal Securities Laws Applicable to Limited Partnership Reorganizations

The SEC is responsible for reviewing the accuracy and adequacy of the disclosure in documents provided to investors in connection with a proposed roll up. Such disclosure is both exhaustive and exhausting to read, lengthy, weighty and not easy to understand. The documents do not usually contain an easy to understand summary of the advantages and disadvantages of the transaction, or of the trading history of these issues. Disclosure of NASD members' role in the transaction is provided, as well as the potential for a conflict of interest in receiving compensation for "yes" votes only.

The SEC is also responsible for compliance with the proxy rules. The problem with the proxy rules is that if a dissenting limited partner wants to advise other limited partners of the disadvantages of the transaction, he or she cannot communicate with more than ten other

investors because the communication in and of itself would require a proxy filing. The comment letters we received on our differential compensation proposal state that NASD members are unsure as to what they are permitted to do in contacting and making recommendations to their clients.

Most state securities commissions do not directly regulate roll ups since a "blue sky" exemption from state securities registration is available for securities listed or to be listed on an exchange. Therefore, the protections for investors afforded by state review is not available to participants in roll ups.

III. Views Requested

The Committee's invitation letter also requested our views on trends in roll up activity, potential conflicts of interest when general partners pursue a roll up, and the duties of general partners to limited partners.

A. Trends in Roll Up Activity - We see several potentially encouraging trends in recent roll up activity:

- First, the increased scrutiny of roll up abuses in the past few months has resulted in increased pressure on general partners and the way they structure these transactions.
- Second, recent attempts at roll ups have met with more resistance by limited partners, indicating that limited partners are becoming more aware of the potential for abuse and are taking steps to protect themselves.
- Finally, our comment letters indicate increasing reluctance by NASD members to solicit approval for these transactions because they do not believe that roll ups have a high probability of delivering the benefits promised by general partners.

B. Potential Conflicts of Interest When General Partners Pursue a Roll Up - Roll ups present an inherent conflict in that the general partners have a fiduciary responsibility to act in the interests of their limited partners, while the general partners are also structuring the terms of the roll ups to favor themselves. These are not arm's length transactions, and have strong inferences of self-dealing.

C. Duties of the General Partner to Limited Partners - Under general partnership law, the general partner has a fiduciary duty to act in the best interests of the limited partners. The limited partners must trust and rely upon the general partner's good faith in managing the assets of the partnership since a limited partner, by definition, may have no direct management or decision-making responsibility.

IV. Recent Proposals for Reform

The Committee's invitation letter also requested our comments on several proposals that have been made to reform the roll up process.

A. Need for Proxy Process Improvements? One concern expressed repeatedly by NASD members in their comment letters on differential compensation is their lack of ability to freely advise their customers on roll ups without running afoul of the proxy rules. Members are concerned that the current proxy rules prohibit them from affirmatively recommending that their individual investor clients vote "no" on the roll up, particularly when other brokers may be soliciting their clients' "yes" vote. Clarification or modification of the current rules may be necessary to allow our members to provide objective guidance to their limited partner customers without the danger of violating the proxy rules.

B. Current Disclosure Requirements Adequate? Current disclosure tends to be exhaustively complete, but the huge amount of information made available to limited partners communicates little of what they need to know to make an informed decision on a roll up. Limited partnership investors are generally retail customers, not sophisticated institutional investors, who are intimidated by the sheer size, weight and complexity of the documents. They could benefit greatly from a summary stating the implications of a "yes" or "no" vote. Readability would be greatly enhanced if plain English techniques were employed, such as mandating a specified score on the Flesch readability test, as is required by insurance regulators. Negative aspects of the roll up should be disclosed with more prominence, including the typically poor after-market performance after the roll up is completed.

C. Structural Safeguards Needed to Protect the Interests of Limited Partners?
Structural safeguards that may be needed to protect limited partners include:

- General partners could be required to provide alternatives to dissenters to the roll up, such as a cash payout, a note, or the option of maintaining the original partnership investment, so that limited partners have a choice;
- General partners or sponsors proposing the roll up could be required to incur the costs of the solicitation if the transaction is not approved -- instead of the limited partners -- to eliminate the unfair financial burden on limited partners and to provide an incentive for general partners to structure the roll up in a manner beneficial to limited partners;
- General partners could be prohibited from accelerating their subordinated back-end interest into an equity interest and changing their management fees from an operations-based to an asset-based fee to the detriment of limited partners;

- Partnership agreements in newly-formed partnerships could contain provisions that protect limited partners in the event of a roll up;
- General partners could be prohibited from installing super-majority voting provisions if they were not included in the original partnerships;
- Partnerships could be required to provide detailed financials by property rather than consolidated reports. Detailed reports would provide the information necessary for the market and the participants to better value the securities resulting from a roll up, since the lack of information steepens the discount in the after-market.

D. Alternatives Needed for Dissenting Limited Partners? Alternatives that would greatly enhance the poor position many limited partners find themselves in during a roll up include:

- Allowing limited partners' interests to be redeemed at the appraised value in cash or a combination of cash and a note;
- Allowing limited partners to remain in the existing partnership; or
- Providing a choice of rolling up into either a finite or infinite-life entity.

V. Legislative Proposals the NASD Would Recommend

As a general matter the NASD prefers the flexibility of agency and self regulatory organization rule making to the necessary rigidity of legislation. To the extent that government agencies or self regulatory organizations do not have the authority to make the changes discussed above, we would recommend that they be given the necessary rule making authority. We offer our services in the development of any legislation this committee might consider.

VI. Summary

Although the NASD's role in this area has been a limited one, we believe that our proposal to eliminate differential compensation for "yes" votes is an important step in curbing abusive roll ups. General partners have used their ability to pay NASD members only for "yes" votes as the principal tool for getting these roll ups approved by limited partners. If members can instead make objective recommendations to their clients, unswayed by compensation arrangements, general partners will be forced to structure fairer transactions as well as provide more desirable alternatives for their limited partners. We believe that the NASD proposal, if adopted, should have a significant impact on the fairness and frequency of roll ups in the future. Requiring the general partner to pay for the solicitation when investors reject the roll up would also appear helpful.

In pursuit of our proposal to prohibit the receipt of differential compensation by our members, a meeting of our Direct Participation Programs/Real Estate Committee has been scheduled for April 5, 1991. The Committee will consider our members' comments and make a recommendation on a course of action to the Board of Governors at its meeting in May, 1991. If the Board approves the proposed amendment, it must be submitted to and approved by the SEC before becoming effective. The Committee and the Board will also consider whether other rules are appropriate to address the abuses in partnership roll ups.

I thank you for the opportunity to testify, and I am ready to address any questions you may have.

LIST OF COMMENTERS

A.G. Edwards & Sons, Inc.
American Bar Association
American Investors Company
Anchor National Financial Services, Inc.
Brown & Brown Securities, Inc.
Capital Analysts Incorporated
Chicago Partnership Board, Inc.
Chubb Securities Corporation
Commonwealth Equity Services
Commonwealth of Massachusetts
Commonwealth of Pennsylvania
D.A. Davidson & Co.
DeRand/Pennington/Bass, Inc.
Family Investors Company
FSC Securities Corporation
IDS Financial Services, Inc.
Investment Program Association
James L. Schiller
Kavanaugh Securities, Inc.
Keogler Morgan & Company
KMS Financial Services, Inc.
Krupp Securities Corporation
Liquidity Fund Investment Corporation
Long Grove Trading Company
Mariner Financial Services, Inc.
MFI Investments
MML Investors Services, Inc.
Multi Financial Securities Corp.
Mutual Service Corporation
National Association of Realtors
New England Securities

North American Securities Administrators Association
Ohio Department of Commerce
P. Oppenheimer & Associates, Inc.
Partnership Exchange Securities Company
Partnership Profiles
Pension Investors Securities Corp.
Planned Investment Co., Inc.
Professional Financial Services
Real Estate Investment Association
Robert A. Stanger & Co., L.P.
Schlitt Services
Schofield Investments, Inc.
Stanford Investment Group, Inc.
State of Iowa
State of Maryland
State of Michigan
SunAmerica Securities, Inc.
Thomas M. Nixon & Associates, Inc.
Titan Value Equities Group, Inc.
Transamerica Financial Resources
Vestax
W.P. Carey & Co., Inc.
Wealth Builders Equity Corporation

broad emphasis of Federal securities laws which rely on minimal and far less rigorous disclosure standards.

The current Federal safeguards for rollups contain none of the investor protection safeguards that are the hallmarks of State regulation.

For example, guidelines developed by NASAA and widely used by States across the Nation require the observance of limited partners' voting rights, suitability standards, bans on conflict of interest, and limitations on compensation and fees.

All of these investors protections are erased, wiped out completely, when limited partnerships are restructured in a rollup.

That rollup sponsors are permitted to sidestep the reasonable and proven State level protections for limited partners makes little enough sense to me, but it must seem nothing short of an outrage to the small investor whose hardearned savings suffer as a result of this unsatisfactory handoff of the regulatory baton.

And one can only imagine the delight that is taken by general partners sponsoring a rollup.

For them, the wiping away of State regulatory requirements is a golden opportunity to raid the funds of the limited partners for otherwise impermissible fees and commissions, establish onerous, super majority voting requirements, and create the most egregious conflicts of interest.

What should be done to protect the small investors who now are left virtually defenseless in the rollup process?

Mr. Chairman, NASAA respectfully offers the following steps that Congress could take:

As you are aware, virtually all existing substantive registration standards in Federal securities law reside in the Investment Company Act of 1940.

Accordingly, you may wish to look most closely at the 1940 act as a home for a new Federal rollup standard.

Narrowly drawn expansions of the act have been contemplated and carried out in the past.

For example, in the wake of the 1960's boom in the oil and gas partnership industry, Congress considered the possibility of bringing the regulation of such partnership programs within the scope of the 1940 act.

More recently, Congress, in 1980, incorporated into the 1940 act, a set of standards for business development companies more commonly known as public venture capital funds.

This congressional action serves as a possible precedent for similar action on rollups.

Specifically, we would propose a patterning of improved Federal rollup regulation on existing State-level limited partnership safeguards including:

Democracy rights; compensation and fee limits; conflicts of interest; and more meaningful disclosure.

Congress may also wish to consider taking action on providing dissenters' rights and eliminating differential broker compensation, as well as reforming the proxy process.

It is evident that existing Federal proxy law is unsuited to the unique circumstances of rollup contests.

Therefore, Congress could direct the SEC to make appropriate adjustments to Federal proxy rules.

Mr. Chairman, State securities regulators are dismayed and deeply concerned that the often abusive rollup process has substantially undermined the important safeguards upon which limited partners relied when making their initial investment decision.

Those of us in the States continue to be strongly committed to using substantive standards to police and make as efficient and fair as possible, the initial marketplace for limited partnerships.

However, it is beyond our authority to also shoulder the job of protecting limited partners who get caught in the rollup process.

As you will recall from our important work, last year, with this subcommittee on the epidemic of penny stock fraud, NASAA and its members did not hesitate to call for a more effective State and Federal sharing of the response to a truly national problem.

Today, we are faced with another such situation, the rollup crisis.

No other problem area today in investing cries out so strongly for swift action on the part of Congress.

Federal regulation of a public securities offering which goes beyond partnership governance requirements of State limited partnership law is not an intrusion into States rights.

We stand prepared to provide any and all assistance that is needed as this subcommittee determines how best to cope with the spreading abuses in rollups.

Thank you.

[The complete prepared statement of Dee Harris follows:]



NASAA

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STATEMENT OF DEE HARRIS
DIRECTOR, ARIZONA DIVISION OF SECURITIES
on behalf of the
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION
before the
SUBCOMMITTEE ON SECURITIES
Committee on Banking, Housing and Urban Affairs
U.S. Senate

"PUBLIC LIMITED PARTNERSHIP REORGANIZATIONS"

February 27, 1991

President: John R. Perkins (Missouri) • Secretary: Wade Schwartz (Rhode Island) • Treasurer: Eileen L. Brown (Maryland)
Directors: Susan E. Bryan (Oklahoma) • Stephen L. Diamond (Mass.) • Ralph A. Lanthier (Connecticut) and Richard D. Latham (Texas)
Executive Director: Lee Putnam

Executive Summary

Mr. Chairman, you and your colleagues are to be commended for your important efforts to explore the very serious investor protection issues that arise in connection with public limited partnership reorganizations, or "roll-ups." State securities regulators are gravely concerned that roll-ups deprive small investors of the many and important protections afforded to them under state regulation of limited partnerships. Further, federal securities laws and rules as they are applied to roll-ups in no way compensate for the stripping away of these state-level protections.

NASAA has adopted a comprehensive set of limited partnership registration guidelines which, while custom-tailored to reflect the unique nature of each type of partnership, do share substantive provisions intended to guide the conduct of program sponsors, including:

- o Specific net worth and experience requirements of sponsors;
- o Limitations on sponsors' compensation in amount and form;
- o Prohibitions on certain sponsor transactions and other dealings which involve conflicts of interest;
- o Requirements for limited partners' democracy rights; and
- o Requirements for specific reporting to limited partners.

While most state securities statutes provide for the registration of securities to be "offered" or "sold" to the residents of that jurisdiction, registration exemptions have been put in place for securities listed or approved for listing on the major stock exchanges, certain regional exchanges and the National Market System (NMS). Today, almost all roll-ups of public limited partnerships are exchange-listed or approved for such listing, and thus sidestep state substantive review.

While roll-ups are subject to federal oversight by the Securities and Exchange Commission (SEC), the Commission currently is not authorized to employ in its regulation of roll-ups the substantive approach used by states in the registration of the initial public limited partnerships. In the end, the safeguards used to protect limited partners at the state level are erased

in the roll-up process and are not in any way compensated for by the current minimal federal regulation of roll-ups.

Mr. Chairman, NASAA respectfully offers for your consideration the following steps that Congress could take to strengthen the Commission's ability to protect the interests of small investors in the roll-up process. Virtually all existing substantive registration standards in federal securities law reside in the Investment Company Act of 1940. Accordingly, the Subcommittee may wish to look mostly closely at the 1940 Act as a "home" for new federal roll-up standards. Congress could direct the SEC to develop standards under the 1940 Act in order to restore key protections for limited partners facing the prospect of a roll-up. What is proposed here is a patterning of federal roll-up regulation on the existing and proven state-level safeguards for the initial offering to limited partnership investors, including:

- o Democracy rights;
- o Compensation and fee limits;
- o Conflicts of interest prohibitions; and
- o More meaningful disclosure.

Additionally, Congress may also wish to consider taking action in the following areas:

- o Dissenters' rights;
- o Proxy process reforms.

Mr. Chairman, as you will recall from our work with this Subcommittee last year on the epidemic of penny stock fraud, NASAA and its members do not hesitate to call for a more effective state and federal sharing of the response to a truly national problem. Today, we are faced with another such problem. The wisdom of securities regulation in the United States is that it provides an active and important role for those of us at the grass-roots level to oversee risky and illiquid investments that otherwise would serve as a vehicle for the systematic abuse of small investors. For the federal government is largely reserved the role of coping with truly national and market-wide problems. To this list of national marketplace issues has been added the current roll-up crisis. No other problem area today in investing cries out so strongly and insistently for swift action on the part of Congress.

Mr. Chairman and Members of the Subcommittee:

Good morning. My name is Dee Harris. I am director of the Arizona Corporation Commission's Division of Securities and chairman of the Limited Partnership Roll-Up Task Force of the North American Securities Administrators Association (NASAA). In the U.S., NASAA is the national voice of the 50 state agencies responsible for small investor protection and the efficient and fair functioning of the capital markets at the grassroots level. On behalf of NASAA, I appreciate the opportunity to appear before you today.

Mr. Chairman, I commend you and your colleagues for your important efforts to explore the very serious investor protection issues that arise in connection with public limited partnership reorganizations -- what commonly are referred to as "roll-ups" -- and to give consideration to whether additional investor safeguards in this area are warranted. State securities regulators around the country are receiving a rising number of complaints about roll-ups not only from limited partners, but also from market professionals who are expressing the strong view that their clients -- the partnership investors -- have not been well-served in these deals. Along with my fellow state securities regulators, I am gravely concerned that the roll-up process deprives small investors of the many and important protections afforded to them under state regulation of limited partnerships. Federal securities laws and rules as they currently are applied to roll-ups in no way compensate for the stripping away of these state-level protections and, as a result, are in need of reform to address this very serious problem for a growing number of small investors.

Mr. Chairman, in your letter of February 7, 1991, inviting me to testify at this hearing, you raised a number of issues, including questions about the adequacy of existing securities laws to protect investors in the roll-up process. As a regulator, this is my area of expertise and it is where the bulk of my remarks will focus. If you wish, I would be happy to provide you with my thoughts about the non-regulatory issues raised in your letter of invitation.

State Securities Regulation: Emphasis and Focus

Mr. Chairman, as this Subcommittee is well aware, overseeing the multi-trillion dollar investment marketplace in the United States is an enormous task that directly affects the financial well-being of millions of Americans and requires the close attention of the federal and 50 state governments. While the Securities and Exchange Commission (SEC) rightfully commits its resources to broad, market-wide regulatory activities, state securities agencies devote the bulk of their efforts to those regulatory and enforcement issues which most directly effect small investors.

State securities (or "blue sky")¹ laws provide for the protection of small investors through: the registration of securities offerings; the licensing of broker dealers and their agents; and a wide range of enforcement efforts, including criminal prosecution. Since these state laws date back eight decades, they have been described quite accurately as the United States' "first consumer protection statutes."² For example, the substantive state registration requirements act as an effective and proven "trip wire" for the early exposing of the conduct of abusive and fraudulent investment promoters.

The primary focus of state securities registration requirements is on those risky and illiquid investments, such as limited partnerships and penny stocks, where there is not even a semblance of an "efficient market"³ and, as a result, abuses against small investors are most likely to occur. Among the serious problems that arise in thinly- or non-traded instruments are: a dearth

¹ The securities laws of most states are based on the Uniform Securities Act, which was approved in 1956 by the National Conference of Commissioners on Uniform State Laws (NCCUSL). The states have periodically amended the Act since that time.

² Joseph C. Long, Blue Sky Law, Volume 12, 1985, page 1-3.

³ While many experts argue that there are no truly "efficient markets," the term is used in relation to markets in which actively traded securities with a strong national or regional following generally have all or most publicly-available information incorporated into the price of a particular security. That is, the price of a specific security reflects all its risks and rewards, as determined by numerous and sophisticated market figures, such as independent securities analysts.

of publicly available information; undue influence by the promoters and other insiders; and arbitrary pricing. It is important to note that these registration issues of critical importance to small investors, with the exception of mutual funds, are not dealt with on a substantive basis under federal securities laws.

State Regulation and Limited Partnerships

Limited partnerships are among the riskiest and most illiquid of all instruments in the investment marketplace.⁴ In addition to the absence of a trading market, limited partnerships are distinguished by the fact that they are almost exclusively designed for, and sold to, small investors, many of whom have relatively limited financial sophistication. Since the protection of such individuals from fraud and abuse is the primary focus of state securities regulation, NASAA has adopted a comprehensive set of limited partnership registration guidelines for real estate programs, oil and gas programs, equipment leasing programs, cattle feeding, real estate investment trusts, and commodity pool programs. These Guidelines are used widely by the sponsors of limited partnerships as they structure their deals and also form the basis for state securities agency review of partnership registration filings.

While the Guidelines are custom-tailored to reflect the unique nature of each type of partnership, they do share substantive provisions intended to guide the conduct of program sponsors, including:

- o Specific net worth and experience requirements of sponsors;
- o Limitations on sponsors' compensation in amount and form;
- o Prohibitions on certain sponsor transactions and other dealings which involve conflicts of interest;

⁴ In a syndicated limited partnership, investors turn over their funds to a general partner (or sponsor) who are to manage the partnership's business. Limited partners do not participate in the management and the operation of the partnership's business, nor do they assume any liability, except, of course, for the capital they have contributed to the enterprise. The investments are for a specified duration, after which the partnership's assets will be sold and the partnership dissolved.

- o Requirements for limited partners' democracy rights; and
- o Requirements for specific reporting to limited partners.

For broker dealers, the NASAA Guidelines set out customer suitability standards and limits on overall organization and offering expenses. (Each NASAA Guideline contains specific minimum suitability criteria which a potential investor must meet before purchasing an interest in a limited partnership.) The Guidelines have been revisited and updated periodically in response to changing market and economic considerations.

The NASAA Guidelines for public limited partnerships are used by the professional examiners of state securities agencies across the U.S. (For example, 40 states report that they use some or all of the Real Estate Guidelines.) Once a Uniform Application to Register Securities (Form U-1) is filed with a state, the process of reviewing the limited partnership begins. In a real estate limited partnership, the following elements of "Limited Partner Rights and Protection Provisions" come into play:

- o **Limited partners' voting rights.** Specific limited partner rights must be observed, including those related to partnership dissolution, amendment of the partnership agreements, sale of substantially all assets and general partner removal. These rights may be exercised by a simple majority vote of the limited partners. Rights comparable to those guaranteed under stockholder corporate democracy also must be granted, including the right to call special meetings, demand a vote and obtain lists of names and addresses of all limited partners.
- o **Suitability.** Specific standards for customers are enumerated in the Guidelines, with variations accounted for in the differences in the programs and markets.
- o **Conflicts of interest.** In order to prevent self-dealing on the part of the general partners, compensation standards have been developed in the event that the general partners provide goods and services to the partnership. Compensation for such must be

competitive with that which would be charged by an unaffiliated third party. Also prohibited are loans of partnership funds to the general partners.

- o **Commingling of partnership funds.** Such practices are prohibited. However, a sponsor may establish a master account for the benefit of various affiliated partnerships provided that the funds of one partnership are protected from the claims on the other partnerships.
- o **Fiduciary duty.** The general partners have a fiduciary responsibility for the safekeeping and use of all funds and assets of the partnership and are prohibited from using such funds or assets in any manner except for the exclusive benefit of the partnership.
- o **Financial statements and periodic reports.** In order to protect the limited partners' rights, the NASAA Guidelines require that small investors be provided with audited financial information of the partnership and other periodic and annual reports. Also mandated are periodic financial disclosures relating to self-dealing and transactions with affiliates.
- o **Sponsor's net worth, experience and financial statements.** Thresholds related to the sponsor's net worth and experience must be satisfied. Financial statements included in offering materials must conform to specific standards.
- o **Exchange, transfer and redemption of limited partnership interests.** The Guidelines prescribe the conditions for the admission of the original and substitute limited partners and prohibit mandatory redemptions, with limited exceptions. Also included are provisions governing the transferability of limited partnership interests and limitations on deferred payments.
- o **Termination of the general partner.** Allows limited partners the right to remove the general partner upon majority vote and sets

out provisions related thereto. Any termination of the general partner must be done on terms reasonable to the partnership.

- o **Sponsor Indemnification.** The Guidelines specify the specific and narrow circumstances under which the general partner may tap partnership funds in the event that he or she is sued.

The states routinely work through NASAA to update and modernize the Guidelines. The Real Estate Limited Partnership Guidelines, adopted by NASAA in 1980, have been amended annually since 1983, with the most recent changes being put in place on January 1, 1990. The NASAA Real Estate Committee has convened study groups (which include industry representatives) to examine a wide range of concerns and possible revisions. The Oil and Gas Guidelines, since their adoption in September 1976, have been amended in 1977, 1979, 1983, 1984 and 1987. The dynamic nature of the Guidelines reflects a clear interest on the part of the states to keep abreast of promoter tactics and to harmonize regulatory requirements, where it is possible and in the best interests of small investors.

NASAA also has undertaken additional efforts to preserve the small investor protections at the heart of the various Guidelines. On October 12, 1988, the Association adopted a resolution in support of restrictions on the use of the words "insured" and "guaranteed" as part of the name of a program or in related sales literature. Association members believed that the terms were being used to describe provisions which did not constitute guarantees or insurances, as those terms are commonly understood by small investors. We are pleased that the SEC recently reached the same conclusion, as evidenced in its public announcement earlier this year.

⁵ In 1990, the NASAA committees responsible for limited partnership Guidelines were combined into the Direct Participation Programs Committee. This structural change has in no way lessened the ongoing work in the various partnership areas.

The Regulation of Roll-Ups

While most state statutes provide for the registration of securities to be "offered" or "sold" to the residents of that jurisdiction, several exemptions from these registration requirements have been put in place, as is also the case under federal securities law. Most notable among the state registration exemptions is that which is provided for "any security listed or approved for listing upon notice of issuance" on the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and in most states, certain regional exchanges and the National Market System (NMS) of the National Association of Securities Dealers Automated Quotation (NASDAQ) system.

The "exchange exemption," which dates back roughly 70 years in state securities statutes, is a recognition that certain securities required to meet the qualitative and quantitative standards of the exchanges do not require the additional oversight of state securities regulation. The widespread adoption of exchange exemptions reflected a responsible effort on the part of state securities regulators to relieve such securities in the national marketplace from individual state registration requirements. In more recent years, state securities regulators responded to Congressional and other calls for a national market system through the adoption of a statutory recognition of the NASDAQ/National Market System (NMS) as the functional equivalent of a qualified stock exchange for the purposes of the registration exemption.

Until the 1980s, the nearly singular effect of the exchange exemptions was to remove from the purview of state securities regulation the trading of listed common stock and bonds of nationally known companies. However, recent years have seen the exchanges list certain initial public offerings (IPOs) and roll-ups that were not contemplated when the states originally adopted exchange exemptions. The states' exemptions for exchange-listed securities were predicated on the existence and application by the exchanges of published listing criteria, as opposed to the apparently ad hoc "standards" now being used by the exchanges, particularly for the listing of roll-ups. NASAA and individual state securities regulators have expressed serious concerns to national exchanges about such recent developments, but have received no assurances that such listings will cease.

Today, almost all roll-ups of public limited partnerships are exchange-listed or approved for exchange listing and, therefore, such offerings sidestep state substantive review. The net effect of this process is that individual limited partnerships that had been screened through state investor protection standards are converted literally overnight into investment instruments outside of the ambit of state regulation. In this way, limited partners are effectively stripped of the many and important safeguards required under the NASAA Guidelines.

While roll-ups are subject to federal oversight by the SEC, the Commission is not currently authorized to employ in its regulation of roll-ups the substantive approach used by the states to regulate the initial limited partnerships. Under federal securities laws, there must simply be full disclosure of the factors relevant to the investment in the public limited partnerships. The Commission's rules do not impose any suitability standards for particular investments by customers. Nor do the SEC rules prohibit conflicts of interest by insiders or contain any limitation on the amounts of commissions and compensation payable to the various parties of a partnership transaction. Most importantly, SEC rules do not prevent the roll-up sponsors from entrenching themselves in almost absolute control of the limited partnerships. In the end, the safeguards used to protect limited partners at the state level are erased in the roll-up process and are not in any way compensated for by the current minimal federal regulation of roll-ups.

Suggested Federal Reforms

Mr. Chairman and Members of the Subcommittee, NASAA respectfully offers for your consideration the following steps that Congress could take to compensate for the loss of state safeguards for limited partners and to strengthen the SEC's ability to protect the interests of small investors in the roll-up process. Virtually all existing substantive registration standards in federal securities law reside in the Investment Company Act of 1940. The Act is designed to oversee companies that pool the investments of individuals in order to invest in other operating companies. The parallels between investors in mutual funds and those in limited partnership roll-ups are striking.

Accordingly, the Subcommittee may wish to look most closely at the 1940 Act as a "home" for new federal roll-up standards. The substantive standards of the 1940 Act were put in place in response to widespread and abusive industry practices, including: failure to provide to investors accurate and full disclosure about the investment companies and the management of the same; organization and operation of the investment companies for the express financial benefit of the insiders and to the detriment of investors; failure to secure proper shareholder approval for changes in the control or management of the entity; increases in the speculative nature of the securities through certain transactions; and the use of unsound or unverified accounting methods in the valuation of the assets of the entity and not subjecting the same to independent scrutiny. The vibrant health and rapid growth of the mutual fund industry is clear evidence of the wisdom and effectiveness of the regulatory philosophy embodied in the 1940 Act.

Narrowly-drawn expansions of the 1940 Act have been contemplated and, in fact, carried out in the past. Much like the frequently updated and revised NASAA Guidelines for limited partnerships, the Investment Company Act of 1940 has been a "living law"; it has been studied and even used in response to emerging investment vehicles and promoter tactics. For example:

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- o In the wake of the late 1960s boom in the oil and gas partnership industry (and the widespread evidence and allegations of unfair sponsor self-dealing, misrepresentations and misappropriation of funds), Congress and state and federal securities regulators examined possible means by which to improve investor protections in this area. Congress considered in 1969 the possibility of bringing the regulation of oil and gas partnership programs within the scope of the 1940 Act. While the oil and gas industry was successful at that time in blocking such an approach, it was only able to do so by agreeing to "... cooperate with the Securities and Exchange Commission in working out a reasonable regulatory statute consistent with the need for protection of investors ..."⁶ (It also was made clear that state securities regulators were to be actively involved in this effort.)

⁶ House Rep. 91-1631, 91st Cong., 2d Sess. (1970), p. 27.

Senator DODD. Thank you very much, Mr. Harris.

Let me pick right up on a point.

Chairman Breeden and I talked briefly about this middle ground.

I mentioned this never-never land.

Because dissenters rights basically fall within the jurisdiction of State law.

Obviously, you're right on the rollup, you move into that new entity, then you're sort of shifting over.

And where the investor gets caught is this land that no one seems to really have a handle on.

I expressed the concern that I thought it might be difficult, and I'm intrigued by your last comment, one of your last comments in this area.

STATE ACTION

Should we wait for the States to move on this one?

I'm embarrassed to tell you I can't even tell you what my own State law is on this.

I should know, in Connecticut, what it is.

Should we allow for the States and NASAA to go out and try and promote some along this area, or should we come up and just try and move in with a minimum standard or some legislation across the country, so that we deal with the problem that, even with all the disclosure, and even with some of the suggestions that have been made that Chairman Breeden talked about, you still come back to the problem that, unless you deal with some of those democracy issues you talked about, really, it's going to question whether or not you've really done anything.

Mr. HARRIS. Mr. Chairman, I recommend your latter suggestion, that you set some minimum Federal standards in the case of these public offerings.

Chairman Breeden was referring to State limited partnership law.

State limited partnership law obviously applies to all limited partnerships formed in a particular State.

But that has nothing at all to do with the securities offering.

And these rollups are securities offerings.

And I don't think that any State, either the secretaries of state who typically administer the limited partnership law, or the securities regulators who administer the States securities statutes, would regard it as an intrusion into States rights, for Congress, in the case of a public national rollup, to mandate some minimum standards.

Senator DODD. Do you want to comment on that, Mr. Wilson?

Mr. WILSON. Yes.

I was going to observe that there may be another methodology to treat the problem, though I would concede that it wouldn't necessarily be total, though I think it could be almost that.

It is one approach that would involve the NASD establishing rules which would prohibit its members from participating in the solicitation, if you will, of anything that did not have certain—of any arrangement that did not have certain standards, such as dissenters' rights, or something of that nature.

Another secondary possibility to that would be imposing similar such requirements in the listing standards of the exchanges where these limited partnerships go, and on our own national market system, NASDAQ national market system.

Neither of those would be total, but they'd be almost.

UNDERSTANDING THE DISCLOSURE

Senator DODD. You made some suggestions on the disclosure, the readability and highlighting the disadvantages of the rollup for the limited partner to be able to understand.

Mr. WILSON. Yes.

Senator DODD. I think it was a good suggestion.

I think you obviously heard Chairman Breeden's response to that.

By the way, I should comment and tell you how deeply appreciative we are on the subcommittee for both NASAA and NASD's involvement with this subcommittee.

I'd be remiss if I didn't thank both of you and your organizations. You've been terrific, absolutely the most cooperative not only in terms of testimony and so forth, but just even ideas and suggestions and so forth. And on behalf of the subcommittee, I want to thank you both and your respective members for that—

Mr. WILSON. Thank you.

Mr. HARRIS. Thank you, Mr. Chairman.

Senator DODD [continuing]. Involvement. It's been tremendously helpful, just tremendously helpful.

Let me ask you something here, and I'll make this the last that I'll ask you to comment on, and I'll just do the written questions.

I really appreciate your definitive statement that we just sort of stop this idea of compensating just the "yes" vote.

I mean, you couldn't be any more clear on that point.

Mr. WILSON. I have to say, it has not been approved by our board, yet.

I think it should be, but that's me.

Senator DODD. Yes.

Mr. WILSON. I think it will be.

Senator DODD. Well, I hope it is.

And yet, some have suggested that, well, that's terrific, you know.

That's going to, we think, maybe make a difference, but it's a little more subtle than just a question of compensating for a yes vote.

That you get in here and customer lists and a variety of other things and the pressure on the broker is not insignificant.

And the fact that they don't get paid now just for the "yes" vote doesn't mean that there aren't going to be other ways of kind of inducing the broker to make sure that that "yes" vote is actually what comes out of all of this.

And I wonder if you might comment on that?

Is that a legitimate concern?

Mr. WILSON. Yes. I think it is, and it's an area which I think we'll probably also be addressing.

Because, you could, in your arrangement, propose that you would pay the broker for either a "yes" vote or a "no" vote.

However, also provide that nobody gets paid at all unless it passes.

So unless you have that added protection on the end of the provision, you probably really haven't done much.

So you can't just say, you must pay for "yes" votes or "no" votes, but also that you must pay for them in either event, or not at all.

Senator DODD. Yes.

I agree.

Do you want to comment on that at all, Mr. Harris?

Mr. HARRIS. I agree with that.

Senator DODD. OK.

You do agree with that.

The exchanges. I've got to ask this one, quickly, too.

And I think you've sort of addressed this, Mr. Harris, but I'll give you a chance to expand on it, further.

A lot of the critics are saying, look, you're complaining about what the States are doing or not doing.

You're complaining about what the SEC is doing or not doing.

But a lot of the fault lies with the exchanges, themselves.

They're not doing enough here.

And I wonder if you might comment on what role you think the exchanges can play in this particular issue.

THE ROLE OF THE EXCHANGES

Mr. HARRIS. We would like to see the exchanges have a set of written listing standards for rollup entities.

I think the exchanges, if they did that and if they incorporated into these written standards, some of the kinds of things we're talking about, that go beyond numerical tests.

Typically, the exchanges, as you know, will look at numerical tests, numbers of shareholders, net revenue and so forth.

But if their standards went beyond that to require voting rights and so forth, and to prohibit super majority voting rights, those kinds of substantive tests, I think that would be an enormous leap in the right direction.

Mr. WILSON. Yes, I think, earlier, I alluded to that, as well.

I think that both the exchanges, NASDAQ and NMS could adopt specific standards in the limited partnership area, on the one hand, and the rollup area on the other hand, to address that.

And this is an area we're going to be looking at.

Senator DODD. Well, I would appreciate you giving us, if you're working on some draft language and so forth, that you would be either communicating to the exchanges, themselves, I'd like to see that before it goes.

I think it's not a bad idea.

And I'd be interested in what you've got to say on that.

Mr. WILSON. Yes.

We do not have that language.

Senator DODD. I understand you do not have it, yet.

But when you do, I'd be very interested in it.

I regret that I have to abbreviate this.

It's 3 hours.

It's not necessarily an abbreviation, but I could have taken each panel and spent all morning with you.

And we'll come back with some written questions.

We may even ask some of you to come back as we examine this issue further.

But I found it very interesting and very, very helpful this morning, the testimony of all of our witnesses.

Again, to Ms. Hooker and Mr. Rybicki, who was here from Michigan, we deeply appreciate their presence here.

And we're going to pursue this.

And we want to move on it quickly.

I must tell you, I'm alarmed by the statistics for 1991, and I should ask you:

Do you agree with that?

Mr. WILSON. The statistics?

Senator DODD. Yes.

Do you think that's about right?

Mr. WILSON. I asked Charles Bennett here awhile ago if that was right.

Charles is the director of our corporate financing department, who would be seeing all these things, and he agrees.

Senator DODD. He agrees with those statistics.

Mr. WILSON. Yes.

Senator DODD. That explosion in rollups?

Mr. WILSON. Yes, right.

Senator DODD. Well, I can tell you, for people out there thinking about it, I'm going to be looking at it, and I'm going to be putting a lot of attention on the SEC for regulatory changes.

And I'm going to want to make them.

I'm going to do an effective date.

So that if the people are thinking about this stuff and moving forward, I may do it an effective date retroactively, and legislation, as well.

So if people are thinking they're going to be able to do something quick around here, and get away with it, I'll just put you on notice right now.

I'm going to try my darnedest to discourage you from it, and make you pay a penalty if you rush ahead on it.

Because this is too dangerous, what we're doing out here.

And so I just let you know that's sort of the direction I'm headed in with all of this.

And I thank all of you for being here today.

We'll follow up on this some more.

The subcommittee stands in adjournment until further call of the chair.

[Whereupon, at 12:36 p.m., the subcommittee was adjourned, subject to call of the chair.]

[Response to written questions and additional material supplied for the record follows:]

One important by-product of this heightened attention on oil and gas programs at both the state and federal levels was that it set in motion the process that resulted in the Oil and Gas Partnership Guidelines, which were put in place in some states in the early 1970s and then formally adopted by NASAA in 1976. It was as a result of the concerted state-level effort to respond to the concerns of Congress about oil and gas partnership abuses that further federal action was not deemed necessary at that time.

- o More recently, the SEC was directed by Congress in 1980 to incorporate into the 1940 Act standards for "business development companies," more commonly known as venture capital funds.⁷ At the same time that it did so, the Commission also relieved such companies from the obligation to comply with non-applicable sections of the Act.

The Congressional imposition in 1980 of substantive standards on venture capital companies serves as a precursor for similar action in relation to roll-ups. Therefore, Congress could direct the SEC to develop standards under the 1940 Act in order to restore key protections for limited partners facing the prospect of a roll-up. What is proposed here is a patterning of federal roll-up regulation on the existing and proven state-level safeguards for the initial offering to limited partnership investors, including:

- o **Democracy rights.** Under a simple majority vote, those holding the interests in the rolled-up entity should be able to:
 - amend the limited partnership agreement;
 - remove the general partner;

⁷ Venture capital funds are organized as limited partnerships for the purpose of pooling the monies of the partners for investment in the securities of "high-growth" companies. Originally offered on a private basis, these funds began in the late 1970s and early 1980s to publicly solicit the funds of investors. The 1940 Act defines the criteria under which venture capital funds are considered for federal regulatory purposes to be closed-end mutual funds.

- elect a new general partner; and
- approve the liquidation of partnership properties.

"Supermajority" vote requirements, a common feature in roll-ups, should be expressly prohibited. (Currently, it is a normal practice for state securities agencies to forbid supermajority provisions in the structuring of limited partnership offerings.)

- o **Compensation and fee limits.** Strict limits are placed by state regulators on the compensation and fees available to general partners and others involved in a limited partnership offering. Once the same limited partnerships are rolled-up, the general partners are free of any such restrictions and, as a result, have sought to enrich themselves with multi-million dollar packages of additional compensation, fees and equity stakes not contemplated under the original partnership. These and other such "sweeteners" come at the direct expense of the limited partners.⁸
- o **Conflicts of interest.** Self-dealing and other conflicts of interest are directly and effectively addressed under state regulation of limited partnership offerings. No such protections for small investors exist in relation to roll-ups, which are rife with conflicts of interest of the most egregious sort.
- o **More meaningful disclosure.** Since the promoters of a roll-up proxy contest are asking limited partners to "turn inside out" the nature of their original security, investment objectives and their prospects for profit, it is only reasonable that roll-ups should be held to the highest-possible and clearest standards of disclosure. The misleading of limited partners through the use of overly optimistic general partners' letters, fairness opinions based on incomplete data, artificially generated appraisal and market values, voluminous proxies filled with boilerplate legalese, the

⁸ Many commentators have ascribed to these "sweeteners" a pivotal role in the precipitous first-day and long-term decline in roll-up trading values.

high-pressure methods of proxy solicitation firms and "yes" vote compensation for brokers, renders all but meaningless the disclosure currently provided in roll-ups. The one-sided environment in which roll-up contests are conducted may be described as the antithesis of an "efficient market."

Congress may also wish to consider taking action in the following areas:

- o **Dissenters' rights.** Limited partners opposed to a roll-up should be afforded a reasonable opportunity to preserve or liquidate their original investment. "Cram-downs" in the wake of the slimmed majorities of "yes" votes in a roll-up have emerged as a major and often devastating abuse of small investors. Congress could direct the SEC to establish rules and regulations establishing meaningful dissenters' rights. NASAA would volunteer to provide any and all assistance needed to work through the ramifications and mechanics of such a procedure.
- * **Proxy process reforms.** It should by now be evident that existing federal proxy law and rules are unsuited to the unique circumstances of roll-up contests. The current proxy process was framed with traditional corporate restructurings in mind, where such factors as pre-existing securities, independent boards representing shareholders, the presence of institutional investors and the presumed existence of an efficient market, work to maintain a level-playing field between all parties involved. Clearly, limited partners facing a roll-up enjoy the benefit of no such circumstances and, therefore, Congress could direct the SEC to make appropriate adjustments to the federal proxy rules and regulations.

Conclusion

Mr. Chairman and Members of the Subcommittee, NASAA members have had more than 15 years of experience in working together to protect the interests of limited partners. While we are proud of our accomplishments in

this regard, we are dismayed and deeply concerned that the often abusive roll-up process has substantially undermined the important safeguards upon which limited partners have come to depend. Those of us at the state level continue to be strongly committed to using substantive standards to police and make as efficient and fair as possible the initial marketplace for limited partnerships.

However, it is beyond our authority to also shoulder the job of protecting limited partners who get caught in the roll-up process. As you will recall from our important work last year with this Subcommittee on the epidemic of penny stock fraud, NASAA and its members do not hesitate to call for a more effective state and federal sharing of the response to a truly national problem. Today, we are faced with another such problem. The wisdom of securities regulation in the United States is that it provides an active and important role for those of us at the grass-roots level to oversee risky and illiquid investments that otherwise would serve as the vehicle for the systematic abuse of small investors. For the federal government is largely reserved the role of coping with truly national and market-wide problems, including insider trading and mergers and acquisitions. To this list of national marketplace issues has been added the current roll-up crisis. No other problem area today in investing cries out so strongly and insistently for swift action on the part of Congress. State securities regulators stand prepared to provide any and all assistance that is needed as this Subcommittee determines how best to cope with the spreading abuses in roll-ups.

Thank you.

Testimony for the Record
Senate Committee on Banking, Housing and Urban Affairs

Gerald C. Chichester

I am an ordinary investor who bought into several limited partnerships in the mid-1980's after selling a business. Unfortunately, I have become a sadder, poorer and more cynical investor as a result. Too many of these partnerships turned out to be vehicles which enriched the promoters and general partners, but never delivered any of the promised results to the ordinary investor. As we investors have finally discovered that our investments are withering away, the general partners and promoters have lost their market for new partnerships. This has hurt them financially, as it should.

To compensate for this loss of new partnership fees and income, some of these general partners/promoters have devised a new tactic called a "roll-up" to consolidate several, usually sick, limited partnerships into a Real Estate Investment Trust, known as a REIT. These consolidation proposals are filed as proxies with the SEC and subsequently presented to the limited partners for a vote.

Although typically presented to the limited partners as an effort to shore-up or save the LP's investment, the GP's real (hidden) agenda is to enrich itself. Some combination of the conversion transaction costs and the high and perpetual fees generated by the new REIT reward the GP, who failed the LP's in the previous LP format!

It is my understanding that current SEC regulations pretty much allow this ripoff of the limited partners to proceed as long as all particulars, no matter how egregious, are disclosed in the prospectus. Who among us average investors can read and understand 300 pages of intimidating fine print? Therefore, we typically rely on our investment advisor, usually the broker who sold us the investment in the first place, for advice. Apparently, GP and syndicator's communications with brokers are unregulated by the SEC. Certainly that appears to be the case judging by the following case of Krupp Corporation's communication, as a GP, with brokers about one of the most abusive and one sided "roll-ups" ever proposed.

There is the case of the Berkshire Realty REIT booklet distributed by Krupp to Broker/Dealers only. It is what I call the comic book because it bears so little resemblance to reality. There is some irony that this 13 page simple booklet is distributed to brokers and an intimidating 278 page prospectus is all that goes to the investors. Obviously this document was intended to dis-inform the broker community and influence them to recommend a YES vote on the roll-up to their clients. The first page says, This brochure is designed to provide you with a brief explanation of the offering and should be read in conjunction with the enclosed Prospectus..."

The booklet's "brief explanation" fails to even mention the following critical points:

- 1.The investor is being asked to approve a fundamental change in investment philosophy from a no leverage, low risk approach to a higher risk, leveraged approach.
- 2.The investor is being asked to approve a deal that takes fees previously subordinated to various investor returns (i.e., performance based fees) and now skims them off the top regardless of investor returns.
- 3.The substantial partnership investment (\$126 mil) in very safe and conservative mortgage-backed securities would be liquidated and invested in real estate.
- 4.That this roll-up they are asked to vote for is costing them up to \$19.7 million of their partnerships funds.
- 5.The much vaunted liquidity this proposal offers is at an incredibly steep price. Partnership units bought at \$20.00 and rolled into the REIT at \$15.00, are expected to be liquid (trade) at \$7.00-\$9.00!

There are many other central and important issues omitted, but this illustrates the point that brokers, whom investors rely on for advice in these kinds of matters, are recipients of wholly misleading information from promoters. I suggest legislation that either makes these communications subject to SEC approval or makes the brokerage firms responsible for producing balanced summaries for which they would be responsible. It would then seem that some of the restrictions on what could be conveyed to the investors might be lightened.

This kind of misleading behavior is not the only way GPs hinder a fair and equitable proxy voting process. Theoretically, limited partners can obtain the names of their fellow limited partners for purposes of organizing a dialogue or opposition to a "roll-up" proposal. In fact, this is a myth.

and many other investors can document many futile requests for lists of the names of other investors in their partnerships. The right to obtain these names is included in the original Krupp prospectus, for example, and is an aspect of almost every states' limited partnership law. To date, none of our numerous requests to Krupp have been complied with. It is common knowledge that these kinds of requests are routinely stone-walled by many General Partners and legal action and expense must be incurred before gaining compliance. In any case, by this time it is often too late to effect the outcome. Never mind the onerous SEC regulations they are supposed to comply with. Remember, the typical investor in a Krupp LP has \$14,000 in hard earned IRA money invested. That they should have to hire a lawyer to even begin an opposition process is ludicrous.

I suggest legislation requiring an annual filing with an independent third party escrow agent of the names, addresses, telephone number and investment amount of all limited partners. These could then be released by the escrow agent upon written application by a limited partner who gave assurances of appropriate planned use. This escrow agent would have to be identified in the prospectus and in any proxy solicitation documentation.

I have other suggestions in the areas of preventing cram-downs, contingent fees for "fairness" opinions, differential payments for soliciting proxy votes, SEC regulations effectively hamstringing opposition to GP sponsored proposals, and establishment of limited partner advocate committees to balance the incredible power of general partners. It is my understanding that some draft legislation already exists in most of these areas.

As an investor who has had a series of bad and unfair experiences in several limited partnerships, I am desirous of helping to reform the partnership rules of the game. In these times of difficult credit and capital formation, we must urge Congress to reform and make viable the limited partnership vehicle as a trusted means for financing America's growth and prosperity.

Submitted by: Gerald C. Chichester
84 Wood Pond Rd.
West Hartford, CT 06107
March 7, 1981



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February 26, 1991

The Honorable Christopher J. Dodd
Chairman

The Subcommittee on Securities
Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510-5801

Dear Senator Dodd:

Last October, when I testified before the House Subcommittee on Telecommunications and Finance on partnership reorganizations, I stated that the IPA would continue to address this issue and work with those in our industry and the Congress who share our concern that improvements be made in these securities transactions. Set forth below are recommendations the IPA has developed for investors to ensure that reorganizations and restructurings are carried out in a more disciplined manner.

We recognize that one of the most important aspects of this type of securities transaction involves providing ways for investors who do not wish to participate in the reorganization to remain in a security with substantially the same characteristics as their original investment. In earlier partnership reorganizations, investors who voted against the general partner's proposal to reorganize were often left with no alternative but to join in the new entity. We believe general partners should offer investors, to the extent economically viable, an option to permit them to exit from the reorganization and remain with a security which is substantially the same as the security originally purchased.

Looking ahead to future securities transactions, we urge that any Congressional action respect the needs of a majority of investors who wish to restructure their original program. In weighing reform, Congress and the regulatory agencies should be sensitive to both the interests of a majority who support a transaction and who need flexibility to benefit from business plans designed to overcome a distressed situation or take advantage of other opportunities and the interests of a minority who decide not to participate in the reorganization.

The IPA recommends that the general partner make available to those who elect not to participate in the reorganization one of the following alternatives:

- The option of receiving "Founder's Shares" which would be essentially identical to the securities received by other partners in the new entity but with a "put right". The put right would entitle the recipient to elect to sell the securities back to the partnership's successor entity at a specified time in the future at specified percentages of the securities' pro-rata share of the assets of the entity. This right would lapse if the securities trade at a price above the redemption price before the redemption dates.

The Honorable Christopher J. Dodd
February 26, 1991
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- The option of participating in another entity (including, without limitation, a limited partnership or a REIT) which continues the finite life, self-liquidating nature of the existing partnership and offers the limited partners ownership of an investment with substantially the same investment objectives and characteristics as their existing limited partnership.
- The option of receiving, either immediately or under deferred payment arrangement, cash, cash equivalents (including marketable securities) or a debt instrument for exiting investor's partnership interests based on the fair market value of such interest immediately prior to the proposed partnership reorganization. (There would, however, have to be a limitation on the percentage of equity holders who could elect to receive this consideration.)
- The IPA supports the development of other options designed to preserve either the nature of the limited partner's original investment in the security or the fair market value of each partner's holding immediately prior to the reorganization.

The IPA also supports the development of the concept of a "qualified reorganization" which contemplates minimum standards for proposed transactions. To this end, the IPA believes that general partners in such transactions should be required to provide a minimum of 45 days for limited partners to review and evaluate a proposed transaction prior to voting. In addition, the IPA believes that in the circumstance where a reorganization is proposed by the original sponsor (rather than proposed by an unrelated third party such as in the case of an unfriendly takeover attempt or a "distressed" partnership where a reorganization is initiated by an unrelated third party), there must be reasonable limitations on the management and other fees which can be charged with respect to existing assets to prevent the sponsor from gaining a windfall. In particular, there should be restrictions on the acceleration of unearned back-end fees.

In addition to the alternatives for dissenting investors listed above, we suggest that a "qualified reorganization" would provide specific disclosure requirements and guidelines for how information is presented in a prospectus.

We recommend that disclosure of the terms of a "qualified reorganization" include the following:

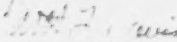
- Prominent disclosure of differential compensation arrangement for soliciting brokers (if applicable).
- Any fees payable to the provider of a fairness opinion which may be contingent upon completion of the reorganization.
- Significant assumptions or limiting conditions applicable to any relevant appraisals.
- Expanded Executive Summary to make the prospectus more manageable for investors.

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We understand that the SEC has undertaken an examination of disclosure in partnership reorganizations and, while we have not seen its recommendations, we hope they will include our suggestions and we look forward to receipt of the SEC's proposals. Those proposals will receive our prompt and full attention.

The IPA is committed to reform in this securities restructuring area and, to that end, is committed to working constructively with the SEC, the NASD and other interested self-regulatory organizations to ensure that an important form of business transaction is addressed with due regard for the interests of the investing public. We believe that the combination of an improved disclosure framework, as is being developed by the SEC, and implementation of the qualified reorganization concept as set forth by the IPA, will significantly improve the partnership reorganization process.

Sincerely yours,


Christopher L. Davis
President

CJD:chf

Coalition of

**Publicly
Traded
Partnerships**

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TESTIMONY OF LETITIA CHAMBERS

President of the Coalition of Publicly Traded Partnerships

SECRET
President of Chambers Associates Incorporated

Submitted for the record of the hearing of the
Subcommittee on Securities
Senate Committee on Banking, Housing, and Urban Affairs

February 27, 1991

SUMMARY OF TESTIMONY

Publicly traded partnerships (PTPs) have been a valuable capital formation vehicle since the early 1980's, used by businesses to acquire assets, pay down debt, avoid further debt, gain market recognition of undervalued assets, and tap previously unavailable segments of the capital market. Not all PTPs are the product of roll-ups; in fact the majority were formed through other methods. Nor do all roll-ups involve the consolidation of several nontraded partnerships into one publicly traded one. There have been roll-ups where the original entities were REITs or PTPs, and some in which the resulting entity was a REIT or corporation. Furthermore, roll-ups are not the only situation in which the life of a partnership is extended. Extensions of finite-life partnerships often occur when the market is not favorable at the time originally specified for liquidation.

Roll-ups are neither inherently good nor inherently bad; they are simply a method of restructuring business entities. Properly undertaken, they can provide investors with benefits which include economies of scale in administrative costs, diversification of assets, greater resources to acquire new assets, and liquidity. Indeed, it is the liquidity resulting from roll-ups that is the motivation for much of the recent criticism. Many of those who wish to restrict roll-ups have are in the business of buying illiquid partnership interests from investors at a discount and reaping a profit when the partnership is liquidated. These critics thus have a vested interest in preserving illiquidity of partnership interests and hastening liquidation of assets.

It is important to remember that even when investors have received less after a roll-up than anticipated from the original investment, they may have fared far better than they would have under the alternatives available at the time of the roll-up. The creation of Southwest Realty, Ltd., is a case in point: consolidation into a PTP allowed the partnerships to survive the real estate depression in the Southwest while several affiliated partnerships who did not roll up lost their assets through foreclosure.

Similarly, the fact that a PTP may result from a roll-up is not, as critics suggest, a detriment to investors. Like any other investment vehicle, particularly those in the energy and real estate industries where PTPs are concentrated, the PTP sector has had its poor performers, but it also has many strong well-managed companies which offer excellent investment opportunities. Unit prices of PTPs have been affected by several factors unrelated to the intrinsic value of the security, including the 1987 and 1990 stock market drops; concerns about the threat of corporate taxation before 1987 and poor understanding of PTPs' tax situation since then; investor unfamiliarity with the vehicle; and investor reluctance to deal with the complexity of the K-1 form.

While the Coalition believes that in many cases factors such as economic conditions, the S&L crisis, and federal restrictions on PTPs were more to blame for investors' dissatisfaction with roll-ups than management abuses, it realizes that there are enough examples of abuse to warrant concern. It also appears that under the current system, investors are not always able to fully comprehend and make an informed decision on proposed roll-ups and other reorganizations, or to have a real chance to successfully oppose those they feel are not in their best interest. The Coalition therefore endorses measures to increase investors' ability to understand the proposed transaction through better disclosure, to receive impartial advice to assist in that understanding, and to have a meaningful opportunity to reject proposal which are indeed unfair or ill advised.

Most of these measures should be within the power of the Securities and Exchange Commission to effect through regulation. The Coalition urges that changes be made at the regulatory level wherever possible, and that Congress minimize overly detailed and inflexible statutes which may burden legitimate transactions and hinder the SEC's ability to adapt to changes in the marketplace.

LETTITIA CHAMBERS
PRESIDENT, COALITION OF PUBLICLY TRADED PARTNERSHIPS AND
PRESIDENT, CHAMBERS ASSOCIATES INCORPORATED
TESTIMONY ON POSSIBLE ROLL-UP REFORMS

The Coalition of Publicly Traded Partnerships is a trade association representing publicly traded partnerships (sometimes referred to as "master limited partnerships" or "MLPs") and those who work with them. Several publicly traded partnerships have been formed through roll-ups of nontraded partnerships, although the majority were the result of corporate spinoffs or liquidations.

Publicly Traded Partnerships and Roll-Ups

Publicly traded partnerships first surfaced in the early 1980s and since then have proven to be a valuable capital formation vehicle. Businesses have used PTPs to raise equity capital to acquire assets or pay down debt, to avoid incurring further debt, to gain market recognition of the value of previously unnoticed assets by spinning them off into a separate entity, and to tap previously unavailable segments of the capital market. From the investor's side, the purchase of PTP units is an affordable way to obtain the benefits of partnership investment while retaining liquidity.

As noted above, not all PTPs are the product of roll-ups. Some PTPs are "roll-outs," formed when a corporate sponsor created the partnership and either contributed assets to it in exchange for partnership units or sold the assets to the partnership. Others are the result of a complete corporate liquidation and reformation as a partnership, although these transactions have ceased since the 1986 repeal of the *General Utilities* rule under which transactions were tax-free.

Nor do all roll-ups involve the consolidation of several nontraded partnerships into one publicly traded one. While there have been several roll-ups of this sort, there have also been roll-ups where the original entities were PTPs and some in which the resulting entity was a REIT or a corporation. Thus one of the principle criticisms of roll-ups, that the investors involved give up a finite life investment with a promised return of capital upon sale of assets for an infinite life vehicle in which the capital return is dependent upon the stock price, is not true of every transaction.

Moreover, roll-ups are not the only situation in which the life of a partnership is extended; nor is such an extension necessarily bad. It is quite common for managers of finite-life partnerships to extend their life if the market is not favorable at the time originally specified for liquidation. Extending the life of a partnership so that the sale of assets occurs in the most favorable market is in fact a rational strategy for maximizing the investors' return.

In addition, the term "roll-up" has been used in some cases, e.g. the Stark legislation to impose an excise tax on certain "rollup transactions," to refer to transactions which, because they involve only one original entity which is bought by or transformed into a REIT or corporation, are more properly termed acquisitions or reorganizations. It is important that Congress keep this distinction in mind in formulating any legislation with regard to changes in structure by partnerships, as the issues associated with a true roll-up may be very different from those associated with a reorganization or acquisition.

The roll-up is simply a method of restructuring business entities which is neither inherently bad or inherently good. Properly undertaken, roll-ups and other partnership reorganizations can benefit investors by providing economies of scale in administrative costs, diversification of assets, greater resources to acquire new assets, and liquidity.* Some rolled up entities have performed well; other roll-ups have not turned out well for the limited partners. While in some cases this was because they were poorly managed or were not a good idea in the first place, in many cases the problem was general or local economic conditions, the depressed state of the oil and gas and (in some areas) real estate industries, the market problems caused in the mid-1980s by PTPs' uncertain tax situation, or other outside factors.

Even in cases where investors have received less after a roll-up than they anticipated from the original investment, it is important to remember that they may have fared far better than they would have under the alternatives available at the time of the roll-up. The assertion that investors in roll-ups would always be better off if partnership assets were liquidated as envisioned in the original partnership agreement is erroneous: in an economic downturn, liquidation of assets may simply not be possible or may produce a minimal return or loss.

For instance, in the case of Southwest Realty, which was cited during the October 3 hearing of the House Energy and Commerce Subcommittee on Telecommunications and Finance (hereinafter "October hearing") as an example of a poorly performing roll-up, consolidating into a PTP allowed the businesses involved to survive the devastating conditions in the Texas real estate market while many other real estate companies fell by the wayside. It is unlikely that these partnerships would have survived the downturn as separate entities. The investors' alternative to this roll-up thus was not a liquidation of the assets and a nice cash return; it was foreclosure or bankruptcy and *no* return.

* With regard to the last point, it is worth noting that some of the more prominent critics of roll-ups have been acting not solely out of concern for investors but out of a financial interest in preserving illiquidity, as they have been taking advantage of the lack of liquidity for nontraded partnership interests by purchasing them from investors at a substantial discount. These purchasers who have bought at a discount anticipate substantial profits when the assets of the partnerships they have bought into are liquidated and naturally oppose any transaction which would extend the life of the partnership.

Because of its roll-up, Southwest Realty survived conditions that many others did not; and while its recovery is not yet completed, its limited partners have a chance that would not otherwise have existed to obtain a real return on their investment in the future. In fact, several affiliated partnerships that did not roll up into Southwest Realty lost their assets through foreclosure, and the partners lost their entire investment. Southwest Realty itself, on the other hand, did not lose any property.

Coalition Concerns

The Coalition's interest in the roll-up issue stems primarily from members' concern over the false impressions that have been conveyed by much of the press and in recent testimony on this issue, namely 1) that all roll-ups involve PTPs, 2) that all roll-ups are bad, and 3) that PTPs are a bad investment vehicle and investors should avoid any roll-up that will result in one. The uninformed observer listening to critics of partnership roll-ups could easily, and erroneously, be led to believe that PTPs are abusive vehicles and that the investor whose original investment vehicle is rolled up into a PTP invariably ends up the loser. Coalition members whose roll-up transactions were undertaken as the best method of preserving their businesses and their limited partners' investment in the midst of highly unfavorable market conditions strongly object to the blanket characterization of general partners as greedy and unethical made by several witnesses at the October hearing.

Moreover, Coalition members in general are concerned that the erroneous equation of PTPs with abusive roll-ups, and charges made in the hearing that both are invariably detrimental to the investor, are making the task of persuading investors to examine PTPs on their individual merits much more difficult. Like any other investment vehicle--and particularly investment vehicles in the energy and real estate industries, where PTPs have tended to be concentrated--the PTP sector has had its poor performers; but it also has many strong, well managed companies which offer excellent investment opportunities.

The fact that unit prices in rolled up PTPs have tended to drop after public trading of the units began, leaving the original limited partners with a loss on their investment, has been attributed by roll-up critics to deception on the part of partnership managers and a supposed recognition by the market that the security is worthless. In fact, PTPs' unit prices have been adversely affected by several factors unrelated to the intrinsic value of the security. These include the stock market drops in 1987 and 1990, which affected PTPs in the same way as corporate stock; concerns about the threat of corporate taxation before 1987 and poor understanding of PTPs' tax situation since 1987; investor unfamiliarity with the vehicle; and investor reluctance to deal with the complexity of the K-1 form. The last three factors have made it difficult for PTPs to market their units to investors. The Coalition has been working to alleviate this problem by persuading investors not to be deterred by the PTP or MLP label but to examine PTPs as they would any other company and take advantage of the ones offering good investment opportunities.

In addition, PTPs in the Coalition are concerned that biased negative attention to roll-ups could persuade Congress to ban them outright. PTPs formed through roll-ups, who found this to be a beneficial means of capitalization, wish to preserve the roll-up as a way of acquiring additional assets in the future. Other Coalition members, particularly those that face corporate tax treatment in 1998, may wish to restructure in the future, either through a true roll-up or through some other type of reorganization. The Coalition believes that when abuses occur with regard to a particular capitalization or restructuring method, the solution is not a complete prohibition on its use, but legislation or regulations that narrowly target potentially abusive transactions while leaving the beneficial ones intact.

Publicly traded partnerships know from their own legislative experience that a groundswell of publicity about perceived abuses in the market may cause Congress to overreact and enact unnecessarily restrictive legislation. In our case, the legislation enacted in 1987 out of unfounded and misguided fears that PTPs would "disincorporate America" has greatly contributed to the difficulties that this security has had in the public markets which witnesses at the October hearing mentioned in their criticism of roll-ups. The Coalition urges that any restrictions be carefully targeted and narrowly drawn so as to avoid similar overreaching in this case.

Concerns Regarding Roll-ups Which Should be Addressed

Despite its objection to the blanket generalization of roll-ups and their managers as unfair and unethical, the Coalition is cognizant of the instances where problems have occurred. There have been roll-ups in which investors did not fare well, and it is clear from the testimony at the October hearing that a significant number of investors in these transactions feel that they were not treated fairly. Although we believe that such factors as economic conditions, the savings and loan crisis, and federal restrictions on PTPs were more to blame in many cases than the alleged management greed, there are enough examples of abuse to warrant concern. It also appears that under the current system the ordinary investor is not always able to fully comprehend and make an informed decision on the proposed roll-up or other reorganization, or to have a real chance to successfully oppose it if he feels it is not in his best interest.

The Coalition therefore concurs with the witnesses at the October hearing who advocated measures to increase investors' ability to understand the proposed transaction, to receive impartial advice to assist in that understanding, and to have a meaningful opportunity to reject proposals which are indeed unfair or ill advised. This will benefit not only investors but, by dispelling the impression that partnership managers do not deal fairly with their limited partners in these transactions, the partnership industry as well. The Coalition is strongly opposed to an outright prohibition, but is willing to consider other substantive measures if it is felt that current law and additional procedural measures are not sufficient to protect investors from the possibility of abuse by partnership managers.

The basis of our system of securities regulation under the 1933 and 1934 Securities Exchange Acts is that if investors are provided with a full, fair disclosure of all relevant information, the marketplace will work to weed out the bad transactions. The Coalition feels that this principle applies to roll-ups as much as to other transactions in the financial markets. If rules are put in place to ensure that limited partners receive all the information they need to evaluate a roll-up proposal, receive it in a form that they can understand, and have a fair chance to oppose the transaction if they feel it is not in their best interests, those roll-ups that are harmful to investors will not go forward. It is our hope that this approach will be given a chance to work before more drastic measures are enacted.

Most of the recommendations discussed should be within the power of the Securities and Exchange Commission to effect through regulation. The Coalition urges that changes be made at the regulatory level wherever possible and that Congress try to minimize overly detailed and inflexible statutes which may burden legitimate transactions and hinder the SEC's ability to adapt to changes in the marketplace. In addition, as was noted by some witnesses at the October hearing, some of the substantive changes such as appraisal rights called for by roll-up critics are more properly within the purview of state regulators.

The Coalition recommendations are discussed with reference to protecting limited partners in roll-up transactions, as that is the issue at hand. We recommend that Congress and the SEC keep in mind the distinction between true roll-ups and other types of partnership reorganization; measures that are advisable for the former may not be for the latter. In addition, we urge that Congress keep in mind that the different considerations involved for privately held partnerships, publicly offered but nontraded partnerships, and publicly traded partnerships. Consideration be given to limiting most of the reforms to roll-ups involving partnerships that are publicly offered but not publicly traded. Limited partners in privately held partnerships are for the most part wealthy and sophisticated investors who do not require the sort of protection that others might, while roll-ups of existing publicly traded partnerships do not involve many of the considerations (e.g., change from finite to infinite life, inability to get out of the partnership before the roll-up occurs) that have been aroused concern.

On the other hand, partnership reorganizations are certainly not the only ones with a potential for abuse--the millions of investors who are now holding worthless junk bonds comes to mind--and the Coalition urges Congress and the SEC to consider whether some of these measures should be extended to situations other than partnership roll-ups.

Coalition Recommendations for Addressing Criticisms of Roll-Ups

CRITICISM: Many investors feel that the proxy statements furnished to them with regard to proposed roll-ups are far too long and complex for the less sophisticated investor to understand, particularly in the short time he is given to make a decision. Information that would be helpful or even essential in deciding whether to approve the roll-up may be missing, scattered through the statement, or in a form that is not easily comprehensible.

SOLUTION: Amend disclosure requirements to ensure that all relevant information is disclosed to investors, and that it is presented in such a manner that it is not overly difficult to read and understand.

- Develop industry guidelines to standardize the presentation of specified information in solicitation materials.
- Require that a concise summary of the advantages and disadvantages of the proposed transaction and its consequences for both investors and management, written in simple, comprehensible English with page references to the more complete discussion in the document, be placed at the front of the solicitation.
- Require full disclosure in the solicitation, also in comprehensible English, of the risks and potential rewards of the transaction to both the investor and management, including 1) the changes in management fees, compensation, rights, and responsibilities, including a before-and-after table; 2) changes in investment policies between the old and new entity, including any change in the estimated liquidation date or liquidation policy; 3) whether partnership expenses will be increased or reduced in the new entity, and an estimate of how much; 4) any transaction fees that will be incurred; and 5) an estimate of the post-roll-up value of the partnership interests, with a full explanation of the factors considered in making the estimate and a clear disclaimer to the effect that the estimate should not be regarded as a guaranteed price, and 6) an estimate of the net after-tax consequences of the roll-up to the partners assuming sale of shares at various values.
- Require that when asset appraisals are used, any significant assumptions or limiting conditions be clearly explained. Require that asset appraisals and financial forecasts be done in accordance with AICPA disclosure guidelines for financial forecasts.
- Require that the same methodology be used in appraising the interests of the limited partners and those of the general partners.
- Require that investors be made aware of issues brought to the attention of the SEC's Enforcement Division during the proxy solicitation period.

CRITICISM: Investors who are unable to understand and analyze the proxy statement on their own may find it difficult to obtain unbiased, reliable advice on the merits of a proposed roll-up. Some of the parties on whom investors are likely to rely for advice often have an incentive to recommend the roll-up.

SOLUTION: Promulgate rules that will eliminate, disclose, or counteract biases that may affect particular investment advisers so that investors may make a better informed judgment.

- With regard to fairness opinions, require disclosure that a fee is paid for the opinion, what investors can and cannot conclude from them, and the implications of the opinion.
- Prohibit payment of brokers only for "yes" votes—they should be paid for both or neither.
- Require the securities firms who sold the original partnership interests or their successors in interest, when either is still in existence, to take a position on the roll-up.
- Create a mechanism within the regulatory process whereby opinion on the proposed roll-up can be received from all interested persons and easily obtained by the general public.
- Require that an objective third party analysis be distributed to investors if one is available."

CRITICISM: Investors who have tried to oppose proposed roll-ups have found that the current proxy solicitation rules make it very difficult and expensive for them to communicate with other limited partners. This may give general partners an unfair advantage by making it impossible as a practical matter for limited partners to oppose roll-ups that are not in the best interest.

SOLUTION: Amend the proxy solicitation rules to provide limited partners with more time and leeway to organize opposition to proposals that they believe are unfair or ill advised. Possible changes include:

- Require disclosure of the proposed roll-up at the time of the first SEC filing, as with new issue registration requirements.
- Extend the minimum proxy approval period for limited partners from 21 to 60 days.
- Amend the proxy rules to allow an unlimited number of limited partners (rather than only ten) to communicate with each other about contesting the general partner's solicitations, and relax the requirements for such communications so as to give limited partners a reasonable chance to make their case while still providing for SEC review.

"It should be noted again that the analysis provided by many roll-up critics is not objective, as they have a vested interest in an illiquid market and in preventing a transaction that would delay liquidation of partnership assets.

- Require the general partners or the managers of the roll-up to distribute to the limited partners on some reasonable basis, e.g., in summary or tabular form, the objections to the roll-up that they have received.
- Amend SEC Reg. Section 241.7028, which prohibits securities firms other than the dealer/manager (the securities firm in charge of managing the roll-up) from providing investors with information or opinion on the proposed roll-up unless specifically solicited to do so, so as to place all parties on an equal footing.

CRITICISM: Critics of roll-ups feel that they result in a drastic change in the nature of the limited partner's investment, i.e., from a finite-life investment in which assets will be liquidated to return the investor's capital at a specified time into an infinite life investment with no guarantee of return of capital. Those who do not want to make this change have no choice, if they are in the minority, other than to wait and try to sell their securities, often for less than the original investment, after the roll-up is completed.

SOLUTION: As noted earlier, roll-ups do not always change the nature of the investment in this way. In any case, as with the other criticisms of roll-up transactions, the Coalition believes that the best solution is to require improved disclosure to ensure that the investor fully understands the nature of the change that will be made and then leave it up to the investor to act on that knowledge. The disclosure should include not only the criticisms cited above but the benefits such as greater liquidity, diversification, enhanced financial resources, and economies of scale that may be realized through the proposed transaction. If a proposed change is detrimental to the investors--and the Coalition does not believe that this is usually the case--investors will reject it once they are fully informed of the facts.

The Coalition believes there is merit in the idea of offering investors a choice between two classes of securities, one allowing retention of the benefits of the original investment and one restructuring the investment, as was done in the CRI roll-ups, and would encourage managers do this to the greatest extent possible. Offering investors a chance to exchange their securities for cash, marketable securities, or a secured note may also be a good idea in some cases. The Coalition opposes writing this into the law, however, either directly or through tax penalties as in the Stark bill. In some cases-- in an economic downturn, when the partnership is reorganizing precisely because it is heavily in debt or lacking in cash, in cases where the principal asset of the partnership is not one that is easily valued or liquidated, to name a few--offering a trade or an alternative security is not a viable option. Partnership managers should have flexibility to take the approach that will prove most effective in their particular situation. If there is full disclosure of the consequences of a roll-up, limited partners should be able to "vote with their feet" by turning down roll-ups that do not provide them with sufficient options.

CRITICISM: Critics assert that in many roll-ups, general partners emerge with greatly increased fees, a larger and unsubordinated share of profits, and unlimited power due to supermajority vote structures.



February 25, 1991

The Honorable John Garn
Ranking Minority Member
Senate Committee on Banking, Housing, and
Urban Affairs
SD-534 Dirksen Senate Office Building
Washington, DC 20510-6075

Dear Senator Garn:

I am writing to you in connection with the hearings on partnership reorganizations (sometimes referred to as roll-ups) before the Subcommittee on Securities scheduled for February 27, 1991. Graham is a co-manager of over 40 limited partnerships representing over \$1.7 billion dollars of capital invested in producing oil and gas properties and other energy-related assets on behalf of approximately 150,000 investors. During most of 1990 our company engaged in substantial analysis and preparation for an exchange offer whereby the limited partners of those partnerships would have been invited to consolidate with Graham into a newly created publicly traded corporation. Primarily because of the equity market instability that occurred in the fall of 1990, we deferred our pursuit of the transaction. While our activities have been discontinued at this time, the factors which led us to consider the consolidation transaction, for the most part, have not changed. We are concerned that legislation might effectively prevent transactions which may be in our partners' best interests. I want to provide you information about some successful roll-up transactions and additional insight from a different perspective on this issue.

First, I would like to tell you what motivated us to consider proposing our consolidation. In reviewing the overall asset base of the partnerships, we realized that until Iraq invaded Kuwait, the pricing of oil and gas generally had not met the expectations that existed when the partnership's acquired most of their properties. As a result the partnership's were unable to simultaneously complete normal, anticipated drilling of development wells on the properties and maintain competitive levels of cash distributions. In a number of cases all but the most critical development work was deferred in favor of being able to pay partners' cash distributions. In early 1990, it was believed prudent to embark on an aggressive development program designed to replace, to the extent possible, the production that had naturally declined over time. Additionally, the capital markets were according a substantial premium to independent oil and gas exploration and production corporate equities. We believed that through a corporate consolidation development drilling could be accomplished while offering our investors access to liquidity at the then existing market premiums.

Ours was, indeed, to be a reorganization motivated by opportunity in the marketplace. It is true that some roll-ups have been motivated by financial difficulty. I might point out that similar

motivations, opportunity and need, have usually been the catalyst for reorganizations outside the partnership area as well. The point here is that partnership roll-ups are simply business reorganizations motivated by the same factors that motivate any other business to consider restructuring.

It has also been put forth by some that all roll-up securities perform poorly in the marketplace and that performance is somehow related to the fact that a roll-up occurred. I would argue that it is more likely that value declines suffered after a roll-up in the securities markets are largely a recognition of asset value declines which have occurred prior to the transactions. These declines may also be due to lack of trading history on an exchange for the assets in question. It is well known that many initial public offerings perform poorly at first.

We worked extensively with the Investment Program Association to prepare a white paper last fall prior to the hearings held by the Telecommunications and Finance Subcommittee of the House Committee on Energy and Commerce. I am enclosing a copy of that white paper for your information. I would like to reinforce several points made therein.

- We conclude the oil and gas companies which performed well did so primarily for the following reasons.
 - They were corporate entities in generally sound financial condition.
 - The value of the securities and assets were known to the market because of prior trading history and the existence of objective oil and gas asset valuation standards (SEC 10).
 - The relevant period saw increased institutional demand for oil and gas corporate equity caused in part by a trend among analysts to recommend increased energy weighting in institutional portfolios combined with a relative shortage of these issues.
- We conclude the real estate companies included did not perform well primarily due to the following factors.
 - Poor financial condition prior to reorganization, in large part related to shifting tax policy.
 - Lack of prior trading history and objective real estate asset valuation standards.
 - Lack of institutional demand caused again primarily by tax policy, which discouraged institutional investment in publicly traded partnerships by classifying their income as taxable to otherwise tax exempt institutions.
- The publicly traded oil and gas partnerships included generally reflected the same lack of institutional demand as did the real estate partnerships for the same reasons.

I would like to point out that Senator Symms, a member of the Senate Finance Committee, recently commented that this very same tax policy may have sewn the seeds for some of the bitter fruit we are now harvesting in the savings and loan situation. I would agree.

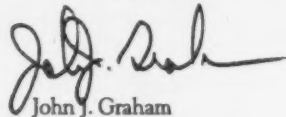
A number of people have urged and will continue to urge that changes be made to the securities laws which would restrict and perhaps even prohibit partnership reorganizations. While we do not advocate legislation, we do believe the following principles should guide any legislation or regulation.

- Since performance in the market has not matched investor expectations in many cases, the issue of valuation accuracy, lack of objective valuation standards and the resulting effects on market performance should be considered.
- Any changes in proxy rules, compensation arrangements and the rights of partnerships to reorganize their business affairs should be applied equally to all forms of business and securities transactions.
- Investors should be afforded reasonable opportunities to dissent and to opt out should they so desire. However, neither the general partner nor the rolled-up entity should be required to subsidize the existence of dissenter owned entities. A number of safe harbor options should be defined to provide appropriate levels of flexibility.
- All essential elements of the transactions should be prominently and concisely disclosed in a manner easily understood by investors.
- The federal government should continue its long held policy of not acting as merit reviewer of securities transactions.

I would like to summarize our views. There are two major issues, market performance and procedural matters involving limited partner rights, compensation arrangements, etc. The issue of market performance has had little, if anything, to do with roll-ups and a great deal to do with asset valuation, shifting tax policy, institutional investment behavior, and the overall economic performance of the industries involved. As to procedural matters, we recognize the existence of legitimate issues, however, legislation to deal with these issues should be considered in relation to the entire spectrum of transactions to which they might be applied.

We at Graham stand ready to provide any assistance you or your colleagues and staff might desire during the legislative process.

Very truly yours,



John J. Graham
President

cc: The Honorable Christopher J. Dodd
The Honorable Donald W. Riegle, Jr.
The Honorable John Heinz

The Misperception About Partnership Reorganizations

Reorganizations, mergers and consolidations are not unique to limited partnerships, but are an integral part of American commerce today; and the most credible measure of the success of any particular reorganization is the performance of the new security in the marketplace.

After reading this report, we hope you will agree that the following observations are relevant:

- ◆ Media reports that the market price of all roll-up securities have dropped like rocks have been greatly exaggerated.
- ◆ Corporate stocks issued in partnership reorganizations have generally performed well while partnership units have not.
- ◆ Institutional ownership is significantly higher in corporations than in partnership units and is positively correlated with the price performance of the companies' stock.
- ◆ This institutional buying behavior was dictated by the UBTI/MLP provisions of the 1987 Tax Act.
- ◆ Legislative overkill is not economically advisable or necessary to redress any legal deficiency in the "gang of four" transactions.
- ◆ Poor business fundamentals, not something inherently wrong with roll-ups, resulted in most partnerships' poor stock market performance.

The financial press has popularized the term "roll-up" and has made us all too aware of those that have not been successful. We have all read about them in the Wall Street Journal and other publications. Mentioned prominently in the media have been such names as National Realty L.P., Centennial Group, Inc., American Real Estate Partners L.P., and Southwest Realty Limited (the so-called "gang of four"). Included as Exhibit 1 are tables and charts showing price performance of these securities before (if available) and after their reorganization transactions.

The financial media, like the non-financial press, tends to publish the unexpected and the bad while leaving the expected and the good to go unnoticed. Transactions involving partnership reorganizations that have not appeared in the press, but which have shown steadily increasing post-reorganization values include Apache Corporation, Devon Energy Corporation and Edisto Corporation. Exhibit 2 contains similar tables and charts for these companies.

Media reports that all roll-up securities have dropped like rocks are greatly exaggerated.

In analyzing data covering both successful and unsuccessful transactions, two distinguishing factors were generally evident; (1) transaction structure and (2) financial strength.

With regard to transaction structure, the successful transactions involved exchanging units of one or more limited partnerships for stock in a single corporation. The unsuccessful transactions, in most cases, involved exchanging units of multiple, non-traded limited partnerships for units in a new publicly traded limited partnership.

Corporate stocks issued in partnership reorganizations have generally performed well while partnership units have not.

While it is not a perfect correlation, there is a very strong, clear relationship between institutional ownership and market performance. The institutions have boycotted traded limited partnerships for the past two years and those units have uniformly performed poorly.

The common factor distinguishing the winners from the losers was institutional ownership of the equity after the reorganization. The corporations averaged a whopping 38.3 percent institutional ownership while the master limited partnerships averaged only .5 percent (see Exhibits 3 and 4). Institutions account for over 70% of all buy transactions on the New York Stock Exchange. With institutions essentially boycotting purchases of master limited partnerships, but favoring corporate structure, it is easy to see why limited partnerships reorganized into corporations soared in the stock market while those reorganized into master limited partnerships crashed.

Analysis of publicly traded energy partnerships, which have generally performed better than their real estate cousins, demonstrates the lack of institutional ownership and the corresponding negative market performance since 1987. While this has been a period of generally favorable market conditions for energy equities, all but two of these have declined in value. (See Exhibits 5 and 6.)

Not surprisingly, market performance correlates positively with institutional ownership for energy corporations (Exhibits 7, 8 and 9), including two that have only gone public since 1987. Among the corporations, none have declined in value while the group averaged an increase of over 58 percent in value during the same time frame, and institutional ownership averages 38 percent of the outstanding stock.

Institutional ownership is significantly higher in corporations than in partnerships and is positively correlated with the price performance of the companies' equity securities.

The primary reason for this institutional behavior lies in the 1987 tax act. In 1986 and 1987, the Treasury Department and Congress were concerned about federal revenue losses resulting from a perceived trend toward conversion of corporations into publicly traded partnerships. The so-called "disincorporation of America" was believed to have the potential to eviscerate the corporate-level income tax. To discourage the further formation of publicly traded limited partnerships, the Congress enacted a provision in the 1987 tax act that deemed all income from publicly traded limited partnerships to be Unrelated Business Taxable Income (UBTI) regardless of the underlying nature of the income. Since UBTI is taxable, even to tax-exempt entities, such entities are disinclined to invest in publicly traded partnerships. Institutions comprise over two thirds of all buyers of investment securities today. It is difficult to imagine how any security could appreciate in value in a market where institutions are frozen out by the tax laws.

This institutional buying behavior was dictated by the UBTI/MLP provisions of the 1987 Tax Act.

The financial media and other detractors have concluded, based upon the infamous "gang of four" real estate transactions so often mentioned, that Congress should effectively legislate partnership reorganizations out of existence.

The more sober conclusion from the preceding, less emotional analysis is that performance in the market has little, if anything, to do with whether a so-called "roll-up" has occurred. Performance is more influenced by transaction structure (whether corporation or master limited partnership) and the resulting effect on institutional ownership. The markets have responded to the 1987 tax act; perhaps not as Congress intended, but they have responded nonetheless.

To implement draconian legislation designed to eliminate reorganizations of partnerships into potentially more attractive investments is an unnecessary and unwise restriction on the U.S. capital markets at a time when capital formation will be especially important to our national economic well being. If there was something amiss in the "gang of four" transactions, other than lack of institutional interest, it hardly seems necessary to use a Congressional hammer to kill that fly.

Legislative overkill is not economically advisable or necessary to redress any legal deficiency in the "gang of four" transactions.

The other factor that influenced the performance of securities after so-called roll-up transactions was the financial viability of the business. As of March 31, 1990, the average of debt-to-total market-capitalization ratios for those companies whose securities declined significantly in value was 81.5% while the same average for the successful transactions was 27.5%. While debt-to-equity ratio is not the only measure of financial health, it does show that if highly leveraged companies own cyclical assets, such as real estate and oil and gas, those cyclical peaks and valleys will disproportionately impact the equity element of the company when they occur.

A review of the most recent SEC filings for the "gang of four" mentioned as non-performers (National Realty L.P., Centennial Group, Inc., American Real Estate Partners, L.P. and Southwest Realty, Ltd.) shows that some or all the following factors contributed significantly to the poor performance of each of those equity securities.

- ◆ Cash flow problems related to inability to replace short-term bank financing with long-term debt or equity primarily caused by:
 - lack of access to equity markets resulting from the crash of October 1987,
 - lack of access to bond markets resulting from pending legislation regarding deductibility of "junk-bond" interest, and
 - lack of availability of savings and loan financing resulting from well-documented troubles in that industry.

- ◆ Overbuilding of real estate in the early 1980's as a result of incentives (primarily shortened depreciation lives) included in the 1981 tax act and a real estate exemption from the "at-risk" rules, which were imposed in the 1984 tax act.
- ◆ Lack of marketability of real estate resulting from the lengthening of depreciable lives and implementation of the "passive activity loss rules," both of which occurred in the 1986 Tax Reform Act.
- ◆ Lack of rental demand resulting from the aforementioned overbuilding and rolling regional recessions particularly in certain areas such as the South Central and Southwest.

It is clear that these factors were not affected by or related to the fact that these companies were involved in "roll-ups".

Poor business fundamentals, not something inherently wrong with roll-ups, resulted in most partnerships' poor stock market performance.

The financial media have also attacked partnership reorganizations because of a perception that the general partner is forcing its will upon the investors. The facts are that all partnership agreements have "democracy provisions" which provide for a majority-based decision-making process. This is entirely consistent with the way we as a society elect public officials, impose taxes and decide matters of public policy. These provisions were designed by the National Association of Security Administrators to protect limited partner investors (1) by limiting the general partners' authority and (2) from the tyranny of the veto by a minority interest. This issue has not been raised in the media in connection with any of the transactions which have been classified as successful.

Though the media and others have advanced the theory that the unsuccessful transactions somehow served investors poorly because they involved "roll-ups", it is abundantly clear that transaction structure, institutional ownership and business fundamentals, such as financial strength and supply of and demand for the companies' product, had far more to do with stock market performance than any connection with partnership reorganizations.

Exhibit 1 Contd.

Comparative Stock Prices of
Real Estate Partnerships

<u>Date</u>	<u>American Real Estate Partners, L.P. IPO Price \$20</u>	<u>Centennial Group, Inc. IPO Price \$1</u>
2Q86	Not Traded	Not Traded
3Q86	Not Traded	Not Traded
4Q86	Not Traded	Not Traded
1Q87	Not Traded	Not Traded
2Q87	Not Traded	\$5.63
3Q87	\$16.00	6.13
4Q87	14.63	3.25
1Q88	15.25	5.00
2Q88	16.13	3.88
3Q88	16.00	3.88
4Q88	15.13	3.38
1Q89	14.75	2.75
2Q89	13.63	2.00
3Q89	12.25	1.88
4Q89	10.50	1.50
1Q90	11.00	1.13
2Q90	10.88	0.88

(1) Prices prior to 1989 have been adjusted to reflect a 5-to-1 reverse

Source: Smith Barney, Dow Jones Data Base

(L.P.) Q	National Realty L.P. (1) <u>IPO Price \$50</u>	Southwest Realty (L.P.) <u>IPO Price \$20</u>
-------------	--	---

Not Traded	\$7.00
Not Traded	4.88
Not Traded	3.13
Not Traded	3.38
Not Traded	2.50
Not Traded	3.13
\$17.50	1.50
12.50	1.63
16.25	1.50
15.00	1.25
10.65	0.81
11.25	0.75
8.88	0.81
5.75	1.63
2.38	1.13
4.13	1.13
5.00	1.25

split

SOLUTION: Again, the Coalition recommends that this complaint be addressed through better disclosure rather than caps on management fees or other substantive restrictions such as those proposed in the October hearings. Results such as increases in management fees or an increased share of profits following a roll-up are not necessarily abusive. Certainly they should be closely scrutinized by investors, but the possibility that they are justified by cost savings or the need to provide an adequate incentive for managers to invest time and money in a necessary reorganization should not be rejected out of hand.

This is especially true in the case where new partnership management is part of the roll-up proposal. The new managers will require a reasonable return for their investment of time and money to make the new entity work. Providing them with that return will generally require a restructuring of compensation, but the benefits of new and better management may be well worth it in the long run.

As noted above, the Coalition does believe that steps should be taken to ensure that investors are fully aware of the benefits that general partners will receive from the roll-up so that they will be able to make an informed judgment as to whether or not they are reasonable and justified. The nature of general partners' fees, compensations, and prerogatives (including the fact that a supermajority will be needed to remove them, if this is the case) both before and after the roll-up should be clearly spelled out in the proxy statement and in the short summary at the beginning of the statement. Ideally, this should be done in chart form somewhere in the document for maximum ease of comprehension.

General partners should be able to include with these disclosures a discussion of why they feel that changes to which limited partners may object are justified. For example, general partners may present tables showing that the projected long-run cost savings from consolidation of several partnerships will exceed the cumulative fee increase; or they may show that increased administrative costs are due to the added administrative expense entailed by trading on an exchange and express their belief that the benefits of greater liquidity are worth the added expense. Such discussions would, of course, be required to disclose all information relevant to the sponsors' argument and avoid misleading statements.

Conclusion

Partnership roll-ups, like other restructurings of business entities, may be undertaken for any number of reasons, and with any number of results. Clearly, there have been roll-ups that proved to be detrimental to the limited partners involved, and some of these may have been undertaken more for the benefit of the general partners than for the investors. It is a mistake, however, to jump to the conclusion that this is generally the case.

It is evident that at least some limited partners have suffered from an inability to fully understand the transaction that was proposed to them and to successfully oppose the general partners in cases where they believed the transaction to be unfair. Securities laws should

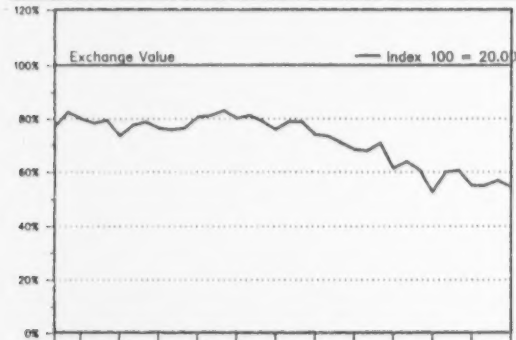
be amended to ensure that each limited partner receives full disclosure of all information relevant to his decision whether to approve the roll-up, including the benefits to the general partners, the ways in which the nature of his investment will change, and expected changes in value, taxation, and overall risk associated with the roll-up. This information should be presented in a form that the average person can read and understand with little difficulty.

Steps should also be taken to ensure that investors have access to unbiased advice on the proposed transaction, and that they are aware of all the factors that may bias the advice they receive. Finally, proxy rules that unduly restrict limited partners' ability to organize and oppose a roll-up they consider unfair should be changed so that such partners have a meaningful chance to prevail.

If these steps are taken, the workings of the market should take care of the abusive and unfair roll-ups, while allowing those that are beneficial and economically justified to go forward. If this occurs, partnerships as well as investors will benefit from the assurance that partnership reorganizations are being carried out in a fair and financially responsible manner.

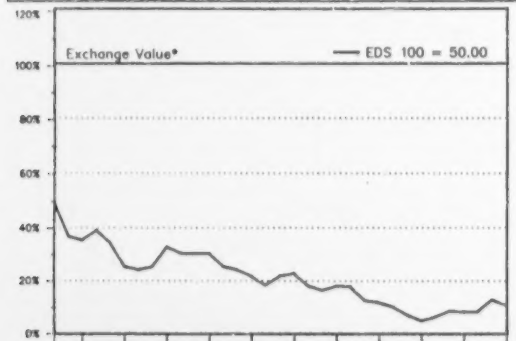
EXHIBIT 1

AMERICAN REAL ESTATE PARTNERS L.P.



SOURCE: Smith Barney, Dow Jones Data Base

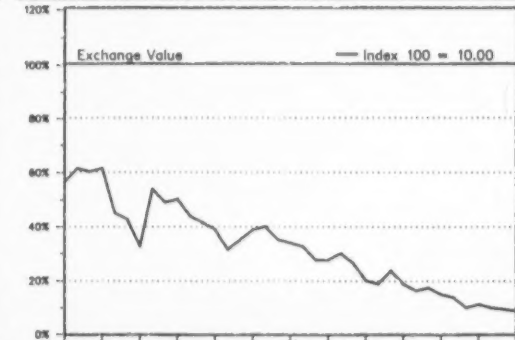
NATIONAL REALTY L.P.



SOURCE: Smith Barney, Dow Jones Data Base

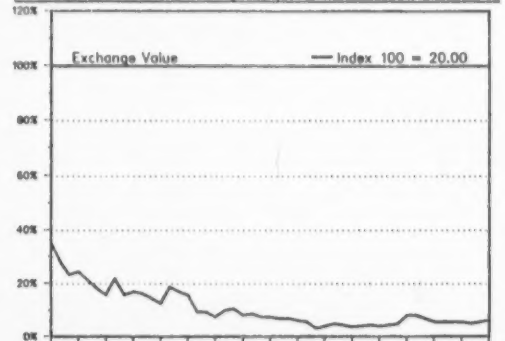
* Exchange Value and prices prior to 1989 have been adjusted to reflect a 5-to-1 reverse split.

CENTENNIAL GROUP, INC. (L.P.)



SOURCE: Smith Barney, Dow Jones Data Base

SOUTHWEST REALTY (L.P.)



SOURCE: Smith Barney, Dow Jones Data Base

Exhibit 2 Contd.

Comparative Stock Prices of
Corporations

<u>Date</u>	<u>Apache Corporation IPO Price \$4.69</u>	<u>Devon Energy Corporation IPO Price \$8.04</u>	<u>Edisto Resources, Inc. IPO Price \$11.99</u>
4Q87	\$7.75	Not Traded	Not Traded
1Q88	8.13	Not Traded	Not Traded
2Q88	7.50	Not Traded	Not Traded
9/23/88		\$6.25	
3Q88	6.63	5.88	Not Traded
10/14/88	6.88		
4Q88	7.88	4.75	Not Traded
1Q89	8.88	6.88	Not Traded
2Q89	11.88	8.56	Not Traded
3Q89	14.88	9.00	Not Traded
12/15/89			\$11.99
4Q89	18.38	13.50	17.25
1Q90	16.25	12.63	17.50
2Q90	15.88	13.25	18.00

Source: Smith Barney, Dow Jones Data Base

Exhibit 3

**Institutional Ownership of Partnerships
As of March 31, 1990**

<u>Partnership</u>	<u>% Institutional Ownership</u>
American Real Estate Partners L.P.	0.5%
Centennial Group, Inc. (L.P.)	1.0
National Realty L.P.	0.3
<u>Southwest Realty Ltd. (L.P.)</u>	<u>0.1</u>
Average %	0.5%

Source: Adams & Rinehart, Inc.

Exhibit 4

**Institutional Ownership of Corporations
As of March 31, 1990**

<u>Corporation</u>	<u>% Institutional Ownership</u>
Apache Corp.	5.1%
Devon Energy Corp.	19.6
<u>Edisto Resources Corp.</u>	<u>49.2</u>
Average %	38.3%

Source: First Boston, Adams & Rinehart, Inc.

Exhibit 5

**Institutional Ownership of Energy Partnerships
As of March 31, 1990**

<u>Partnership</u>	<u>% Institutional Ownership</u>
Belden & Blake Energy Co. (L.P.)	2.6%
Hallwood Energy Partners, L.P.	3.7
Mesa Limited Partnership (1)	23.3
Parker & Parsley Development, L.P.	1.1
Petroleum Investments Ltd. (L.P.)	0.6
Samson Energy Co., L.P.	0.9
Santa Fe Energy Partners L.P.	0.8
Sun Energy Partners, L.P.	0.1
Texas Meridian Resources (L.P.)	0.8
<u>Union Exploration Partners</u>	<u>0.2</u>
Average %	3.4%

(1) Institutional ownership acquired prior to 1987

Sources: First Boston, Adams & Rinehart, Inc.

Exhibit 6

Current and Historic Stock Prices
of Selected Oil and Gas MLPs

<u>Company</u>	<u>Dec. 1987</u>	<u>Stock Price June 29, 1990</u>	<u>% Change</u>
Belden & Blake Co. (L.P.)	\$5.00	\$2.63	-47.4%
Hallwood Energy Partners, L.P. (1)	15.00	8.88	-40.8
Mesa Limited Partnership	10.25	4.50	-56.1
Parker & Parsley Development, L.P.	14.38	17.00	18.2
Petroleum Investments Ltd. (L.P.)	0.94	0.34	-63.8
Samson Energy Co., L.P.	12.13	15.13	24.7
Santa Fe Energy Partners, L.P.	14.50	5.25	-63.8
Sun Energy Partners, L.P.	13.63	10.75	-21.1
Texas Meridian Resources (L.P.)	0.56	0.31	-44.6
Union Exploration Partners	14.50	14.25	-1.7

Average %

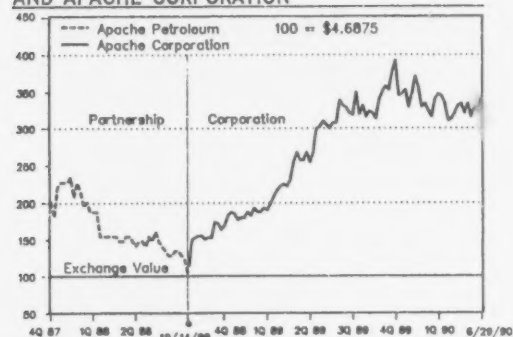
-29.60%

(1) Adjusted for a 1-to-20 reverse stock split

Source: Dow Jones Data Base

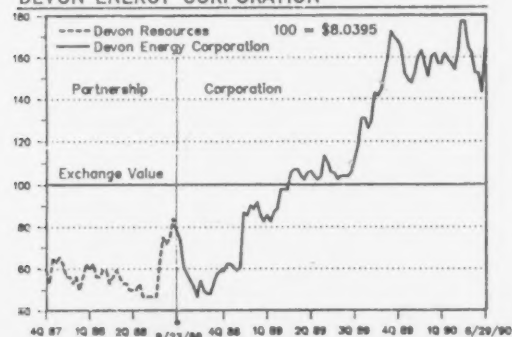
EXHIBIT 4

APACHE PETROLEUM (L.P.) AND APACHE CORPORATION



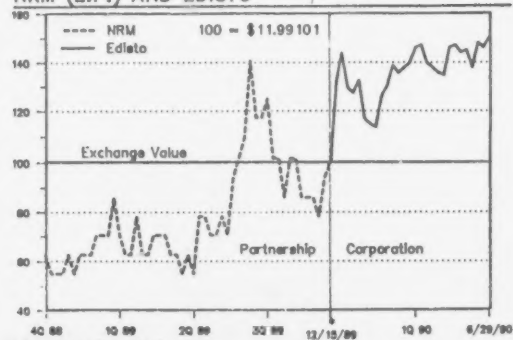
* Corporate Consolidation Date
SOURCE: Smith Barney, Dow Jones Data Base

DEVON RESOURCE (L.P.) AND DEVON ENERGY CORPORATION



* Corporate Consolidation Date
SOURCE: Smith Barney, Dow Jones Data Base

NRM (L.P.) AND EDISTO

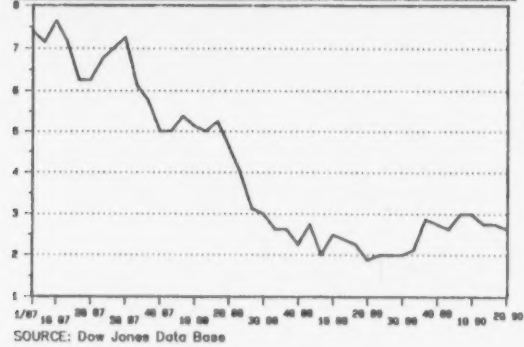


* Corporate Consolidation Date
SOURCE: Smith Barney, Dow Jones Data Base

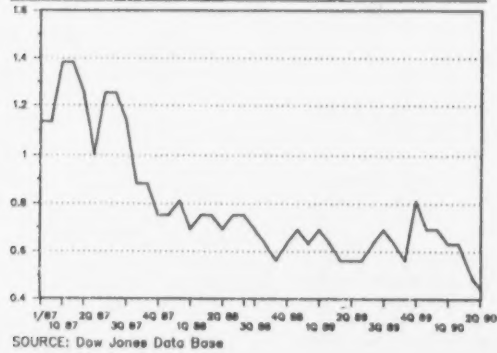
EXH2/75

EXHIBIT 6 Contd.

BELDEN & BLAKE ENERGY CO. (Limited Partnership)



HALLWOOD ENERGY PARTNERS, L.P.



MESA LIMITED PARTNERSHIP

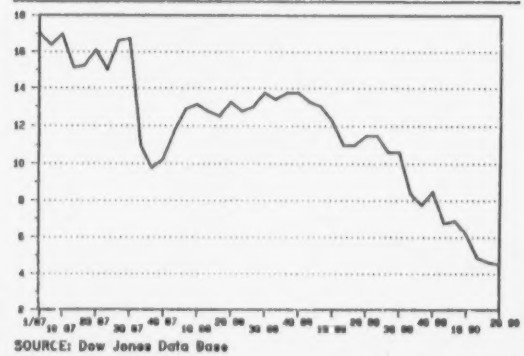
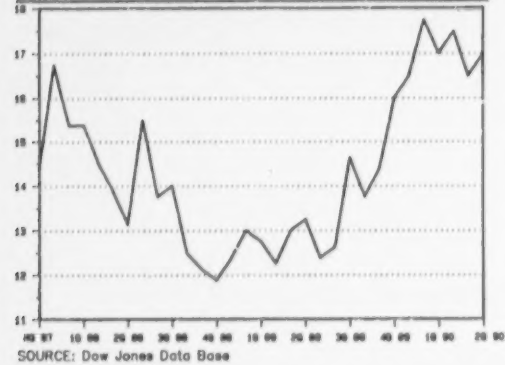
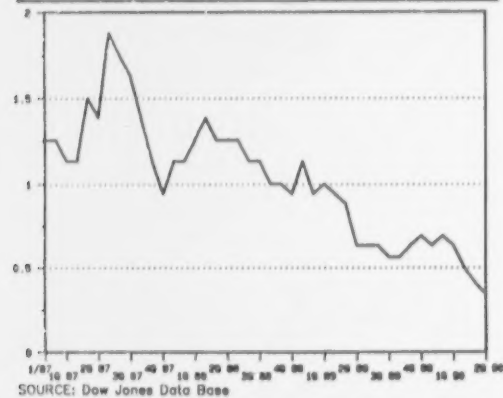


EXHIBIT 6 CONTD.

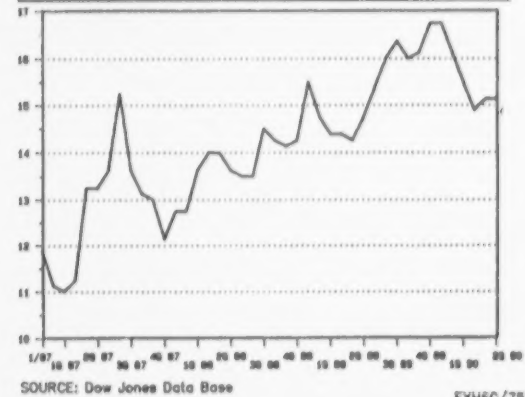
PARKER & PARSLEY DEVELOPMENT PARTNERS



PETROLEUM INVESTMENT L.P.



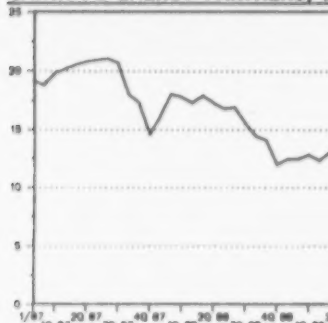
SAMSON ENERGY CO., L.P.



EXH6C/75

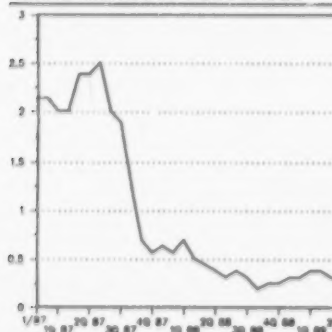
EXHIBIT 3 CONTD.

SANTA FE ENERGY PARTNERS, L



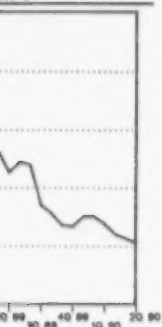
SOURCE: Dow Jones Data Base

TEXAS MERIDIAN RESOURCES

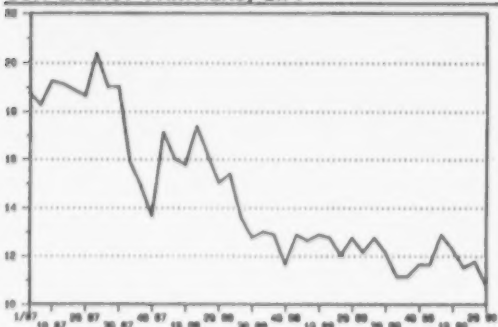


SOURCE: Dow Jones Data Base

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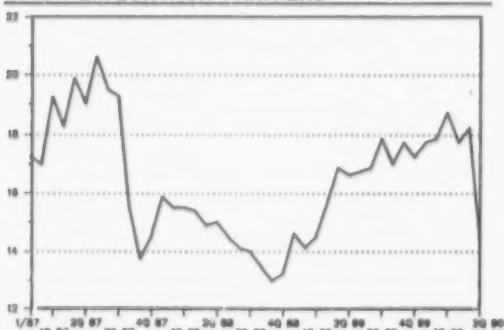
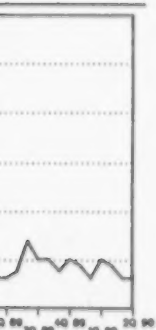
SUN ENERGY PARTNERS, L.P.



SOURCE: Dow Jones Data Base

168

UNION EXPLORATION PARTNERS



SOURCE: Dow Jones Data Base

EXHIB/75

Exhibit 7

**Institutional Ownership of Energy Corporations
As of March 31, 1990**

<u>Corporation</u>	<u>% Institutional Ownership</u>
Adobe Resources Corp.	26.4%
Anadarko Petroleum Corp.	53.1
Apache Corp.	46.1
Dekalb Energy Co.	37.9
Devon Energy Corp.	19.6
Edisto Resources Corp.	49.2
Enron Oil & Gas Co.	11.9
LL&E	66.9
Maxus Energy Corp.	48.3
Noble Affiliates, Inc.	41.2
Oryx Energy Co.	23.0
Plains Petroleum Co.	55.6
Pogo Production Co.	43.5
Presidio Oil Co.	8.5
The Wiser Oil Co.	45.1
Average %	38.4%

Source: First Boston, Adams & Rinehart, Inc.

Exhibit 8

Current and Historic Stock Prices
of Selected Oil and Gas Companies

<u>Company</u>	<u>Dec. 1987</u>	<u>Stock Price June 29, 1990</u>	<u>% Change</u>
Adobe Resources Corp.	\$5.25	\$11.38	116.8%
Anadarko Petroleum Corp.	23.88	33.50	40.3
Apache Corp.	7.50	15.88	111.7
Dekalb Energy Corp.	22.31	24.88	11.5
Devon Energy Corp.	6.25 (1)	13.25	112.0
Edisto Resources Corp.	11.99 (2)	18.00	50.1
Enron Oil & Gas Co.	20.00 (3)	23.25	16.3
LL&E	34.25	41.75	21.9
Maxus Energy Corp.	7.00	9.88	41.1
Noble Affiliates, Inc.	12.75	15.88	24.5
Oryx Energy Co.	25.00 (4)	42.88	71.5
Plains Petroleum Co.	21.50	31.25	45.3
Pogo Production Co.	3.38	7.25	114.5
Presidio Oil Co.	4.00	6.75	68.8
The Wiser Oil Co.	14.38	18.19	26.5

Average %

57.9%

(1) Stock price as of 9/23/88, date Devon Investors' units were exchanged for Devon Energy Corp. stock.

(2) Stock price as of 12/15/89, date NRM Energy Co. L.P. units were exchanged for Edisto Resources Corp. stock.

(3) 10/89

(4) 10/88

Source: Smith Barney, Dow Jones Data Base

Exhibit 10

**Indicated Market Value of Reserves
As a Percent of SEC-10—MLPs**

<u>Company</u>	<u>Market Value of Reserves as a % of SEC-10 (1)</u>
Belden & Blake Energy Co. (L.P.)	85.0%
Hallwood Energy Partners, L.P.	71.1
Mesa Limited Partnership (1)	104.9
Parker & Parsley Development, L.P.	69.9
Petroleum Investments Ltd. (L.P.)	73.3
Samson Energy Co., L.P.	98.7
<u>Texas Meridian Resources (L.P.)</u>	<u>61.7</u>
Average %	80.7%

(1) Indicated market value = stock market capitalization + debt - non
oil and gas assets; market value is based on market price at 8/22/90;
SEC-10 reserve values are as of 1/1/90; all other values are as of 3/31/90.

Sources: First Boston, Securities & Exchange Commission Form 10-K

Exhibit 11

**Indicated Market Value of Reserves
As a Percent of SEC-10—Corporations**

<u>Company</u>	<u>Market Value of Reserves as a % of SEC-10 (1)</u>
Adobe Resources Corp.	125.0%
Anadarko Petroleum Corp.	173.9
Apache Corp.	166.5
Dekalb Energy Co.	161.4
Devon Energy Corp.	120.7
Edisto Resources Corp.	174.2
Enron Oil & Gas Co.	215.1
LL&E	204.8
Maxus Energy Corp.	167.0
Noble Affiliates, Inc.	173.8
Oryx Energy Co.	226.5
Plains Petroleum Co.	193.7
Pogo Production Co.	138.9
Presidio Oil Co.	153.1
<u>The Wiser Oil Co.</u>	<u>124.0</u>
Average %	167.9%

(1) Indicated market value = stock market capitalization + debt - non-oil and gas assets; market value is based on market price at 9/22/90; SEC-10 reserve values are as of 1/1/90; all other values are as of 3/31/90.

Source: First Boston, Securities & Exchange Commission Form 10-K

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM
FRANK J. WILSON



National Association of
Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006
(202) 728-8000

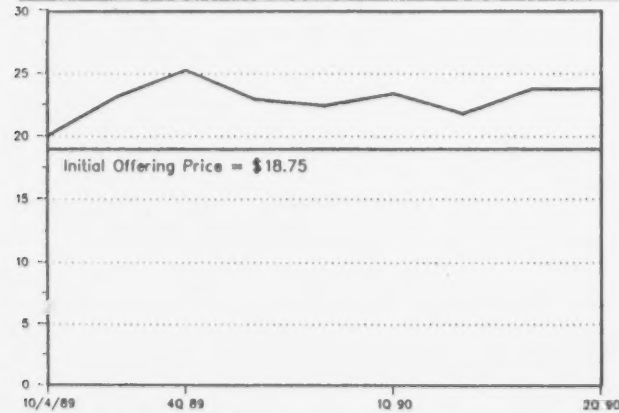
Answers to Written Questions for Frank Wilson, General Counsel and Executive Vice President,
NASD, from Senator Shelby

- Q.1. Is the NASD aware of specific instances of abuse as a result of differential compensation arrangements? Could you provide some examples?
- A.1. The NASD is aware of general partners that have coerced broker-dealers into accepting engagements that provide for differential compensation. The general partners have threatened to turn over partnership lists to another broker-dealer who would then solicit the first broker-dealer's clients.
- Q.2. Is it equitable and appropriate to prohibit differential compensation for partnership roll ups, when it does not regulate the compensation in other forms of restructuring transactions, such as exchange offers where brokers can be compensated for "yes" votes.
- A.2. The instances of abuse which appear to be prevalent in partnership roll ups do not occur in the context of other restructurings. In fact, the NASD has found that corporate restructurings generally have organized opposition, due to the involvement of large institutional shareholders, in instances where the restructuring as proposed is inequitable.
- Q.3. Would simply increasing disclosure to investors of differential compensation arrangements sufficiently protect their interests?
- A.3. No. Increased disclosure to investors will not result in a higher level of protection to investors. NASD members which have commented on the proposal to ban differential compensation believe that differential compensation arrangements are coercive. Meaningful disclosure that provides comparative analysis of a partnership's structure before and after a roll up would be useful. Such disclosure would compare differences between voting rights, general partners' compensation, and valuation of the partnership assets.
- Q.4. Does the success rate of roll ups vary among types of roll ups? For example, are commercial real estate roll ups more or less successful than oil and gas roll ups, etc., equipment leasing, etc.?
- A.4. The success rate of roll ups does not vary among industries such as real estate, oil and gas, and equipment leasing. It must be remembered that the underlying business of the roll up is the management of a non-diversified asset that is subject to cyclical fluctuations in its value and performance. Therefore, when oil is selling for an inflated price, the effect on the assets of an oil and gas partnership is reflected in an increase in the market value of the securities. Similarly, if commercial real estate were in short supply, and rents go to a premium, the underlying share price of a real estate partnership would be driven up. Conversely, in instances of low oil prices or over built real estate markets, the value of the securities declines, and the opposite is true.

- Q.5. Broker-dealers are often compensated only if the client follows the broker's recommendation e.g. in the purchase and sale of securities, in the context of the closing of an underwriting, etc. Is it necessary to change broker-dealer compensation in the context of roll ups?
- A.5. Yes. The NASD membership believes there is a need to prohibit differential compensation. There is a clear distinction between the recommendation of a purchase or sale of securities and the recommendation of a registered representative that its customers vote yes in the context of a roll up. As we stated in the answer to question 3, NASD members believe that differential compensation is coercive. Moreover, in the situation of a recommendation of a purchase or sale of securities, a broker is matching the client's investment preferences and their suitability with a number of different investment opportunities. This is in contrast to a roll up transaction, where a broker is asked to defend a business reorganization to one of their clients and persuade the investor to continue that investment in a different form.
- Q.6. Would it be more consistent with NASD rules to amend Appendix F (per the ABA's comment letter) than it would to prohibit differential compensation for a specific type of transaction?
- A.6. No. Forty-nine of fifty four comment letters received by the NASD were overwhelmingly in favor of banning differential compensation. The ABA's comment letter suggested the use of a qualified independent underwriter that would review the terms of the roll up for its fairness. This concept was specifically discussed by our Direct Participation Program/Real Estate Committee at its meeting on April 5, 1991 and was rejected.
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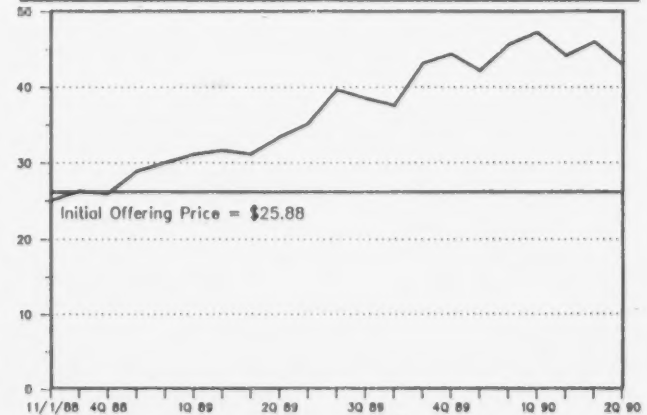
MARKET PERFORMANCE FOR TWO INITIAL PUBLIC OFFERINGS SINCE 1987

ENRON OIL & GAS COMPANY



SOURCE: Dow Jones Data Base

ORYX ENERGY COMPANY



SOURCE: Dow Jones Data Base